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IN THE SUPREME COURT

OF THE

UNITED STATES

OCTOBER TERM, 1924.

No. 273.

MARGARET C. LYNCH, Executrix of the Last Will and Testament of E. J. LYNCH, Deceased,

Petitioner,

vs.

ALWORTH-STEPHENS COMPANY,

Respondent.

RESPONDENT'S BRIEF

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The lessee, as well as the lessor, owned a valuable property interest in the mine, by reason of which under the express terms of the Revenue Act in force in 1917, *the lessee, as well as the lessor, was entitled to a deduction from its gross income, of a reasonable allowance for exhaustion of its leasehold interest by reason of depletion of the mine, in arriving at its net taxable income, but the lessor's and the lessee's deductions were not to exceed the total market value in the mine of the product thereof which was mined and sold during the year, provided that where the interests were acquired prior to March* 1, 1913, *the total allowance so made should not exceed the fair market value in the mine as of that date, the respective deductions of the lessor and lessee to be allowed according to the value of their respective interests in the property as lessor and lessee.* 13

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I.

THE ISSUE

Long before March 1, 1913, the Alworth-Stephens Company became the owner under two mining leases of a vested property interest in each of the Minnesota iron mines here in question, and prior to that date had executed sub-leases to other parties, covering both mines, at a substantial advance in royalty. The Company's property interest in each of the mines in question was gradually exhausted by its use and employment in the business of mining the ore during the year 1917.

The Alworth-Stephens Company has claimed for the year 1917 a reasonable allowance for depletion of its said property and estate in the course of such operations during that year.

This case presents the following question for determination: *Under the Revenue Tax Law as it existed in* 1917, *is a lessee of a mine, who is also a lessor, entitled, as well as a fee owner, to deduct from its gross income for that year a reasonable allowance for the depletion of its property interest in that mine to arrive at its net taxable income?*

STATEMENT

The decision of the District Court by Judge Morris is reported in 278 Fed. 959, and the decision of the Circuit Court of Appeals, written by Judge Sanborn, is reported in 294 Fed. 190, and copied in the Record pages 196 to 202.

The District Court's decision, above reported, sets forth in full its findings of fact, and the Circuit Court of Appeals says concerning this:

> "The finding of facts and the computations of the court below, which it set forth with commendable clearness, accuracy and patience, are not challenged in this court."

The decision written by Judge Sanborn of the Circuit Court of Appeals carefully reviews the statutes and authorities applying to the question here involved and affirmed the lower court's decision. Judge Sanborn's opinion is as clear and forceful a statement as can be made.

The pertinent facts found by the District Court briefly may be summarized as follows:

The Alworth-Stephens Company made its income and excess war profits tax return to the Government covering the year 1917, showing a tax due of $10,253.21, which sum it duly paid. Thereafter the Internal Revenue Department assessed an additional

tax for the year 1917 in the sum of $17,128.44 and forced the Company to pay that amount, which it did under protest on February 21st, 1919.

This action was instituted against the Collector, to recover on the ground that the additional tax was illegally levied and collected, and the judgment and decree ordered the refundment of this amount with interest from the date when it was paid to the Government. The action was started against E. J. Lynch, Collector of Internal Revenue for the District of Minnesota, to whom the tax had been paid. He answered and after the trial died, and his executrix was substituted by stipulation and order, but of course the judgment, under the practice, is to be paid by the Government and is in form only against the Collector and his executrix. The action was tried in the District Court without a jury pursuant to stipulation of the parties (Record p. 16). The findings of the District Court and order for judgment, dated March 30th, 1922, set out in detail the facts (Record pp. 22 to 29). The judgment of the District Court, entered on the same date, for $17,128.44, plus interest, making a total of $20,322.89, is set out at page 31 of the Record.

The Alworth-Stephens Company is a Minnesota corporation, organized in March, 1907, with an authorized capital of $100,000. $25,000.00 of this was subscribed and paid for in cash immediately on organization and certificates of stock were issued therefor. No more stock has ever been paid for or issued. The certificates were outstanding in 1917 (Rec. p. 12).

At the organization of the company, M. H. Alworth assigned to it, an exploratory option from certain fee owners, covering about 5,000 acres of land in Minnesota, which gave the Alworth-Stephens Company the right to take leases on various subdivisions at a royalty of 30c per ton on iron ore, such leases to run for fifty years, and obligated the company to do certain exploratory work . Its two leases were purchased of the fee owners pursuant to this option and in consideration of its fulfilling its agreement with the fee owners.

Certain explorations were conducted by the Company and two mining leases were taken by it from the fee owners and sub-leases made and all of the balance of the lands under the option were released and surrendered to the fee owners. (p. 24). The Company during 1917 had no income whatsoever, except from these two sub-leases, made by it, which mines were known as the Perkins and Hudson mines. (Record p. 23).

Perkins Mine.

In 1908, through explorations conducted by the Alworth-Stephens Company, a small mine located on an eighty-acre tract was discovered, which became known as the Perkins Mine. Pursuant to its option for a lease from the fee owners, the Company called for a lease at 30c per ton royalty, and immediately sub-leased the property at 75c per ton, 30c of which it had to pay the fee owners, its lessors, leaving it a net royalty of 45c per ton (Record pages 24 and 25).

Hudson Mine.

In July, 1908, the Alworth-Stephens Company granted an option for a sub-lease on another forty-acre tract, which thereafter became known as the Hudson Mine, and called for and obtained a lease from the fee owners at 30c per ton and sub-leased this property at 60c per ton, 30c per ton of which amount had to be paid to the fee owners, leaving the Alworth-Stephens Company a net royalty of 30c per ton on this property (Record pages 25 and 26).

These two leases and two sub-leases are the only ones involved in this case, since as early as 1915 the Company surrendered to the fee owners all lands covered by its original option except those covered by these two leases, and never had any other property. On obtaining their sub-leases, the sublessees from the Alworth-Stephens Company proceeded to strip the two mines in question — that is, remove by steam shovel the overburden of earth from

the ore, so that the ore itself could be mined by the steam shovel method (Record pages 26 and 27). This stripping is, of course, a very expensive matter, as it means the entire removal of the surface from the entire ore body, and in such mining operations the surface is sometimes removed from the entire mine to a depth of 150 feet or more, so that railroad cars and engines are run down to this depth and the ore loaded direct from its natural place in the ground into railroad cars and shipped out. We do not mean that the surface in these particular mines was removed to that depth, but it was removed to whatever depth was necessary to reach the ore. This stripping as to these two mines entirely had been completed by 1912, so that the ore was all exposed and ready for loading by steam shovel and could be measured accurately. This work of course rendered the ore as it lay in the ground very valuable in each mine. As the evidence proved, without dispute, and as the court found, the ore was worth, so uncovered, on March 1st, 1913, considerably upwards of 75c per ton (Record pages 26 and 27 and 43 to 57). On March 1st, 1913, it was known that it would take not to exceed seven years from that date completely to remove all the ore from both mines, in substantially equal annual installments (Record pages 26, 38, 50). The ore in both mines was in fact removed and the leases and sub-leases surrendered in considerably less than seven years (Record pages 28 and 29). But figuring seven years, as the court did, for time of removal, is much more favorable to the Government as showing the March 1st, 1913, value of the respondent's interest in the property than the lesser time which it in fact took to remove the ore, for if the lesser time had been figured, the March 1st, 1913, value, and therefore the amount deductible, would have been increased. (p. 39).

The lease from the fee owners to the Alworth-Stephens Company on the Perkins Mine is set forth in Exhibit F, Record pages 124 to 129. The sub-lease from the Alworth-Stephens Company on the Perkins Mines is set forth in Exhibit G, pages 131 to 138. The lease from the fee owners to the Alworth-Stephens Company on the Hudson Mine is set forth in Exhibit I,

Record page 145 to 152. The sub-lease from the Alworth-Stephens Company on the Hudson Mine is set forth in Exhibit J, page 152 to 158.

The leases called for quarterly payments of royalty. The lower court therefore found that the present March 1st, 1913, value of every dollar that the Alworth-Stephens Company would receive from royalties on its property interests in the two mines and leases was 71.9c (Record, pp. 26 and 27), which amount is the March 1st, 1913, average value of a dollar per year, payable quarterly, for seven years, on a 9% discount or risk basis—that is, figuring that the Alworth-Stephens Company would receive its returns from these properties in equal annual installments, paid quarterly, over a period of seven years, the March 1st, 1913, value of the average dollar that it would so receive is 71.9c (Record pages 26 and 27). The court therefore found that in figuring its federal income and war profits tax for the year 1917 the Company was, under the statute, entitled to deduct for depletion 71.9c from each dollar of its *gross income*, to arrive at its *net taxable income*. In other words, that it was entitled to deduct the March 1st, 1913, value of its property interest, represented by the lease, in the ore in place in the mine, which had been mined and sold during the year 1917, in arriving at its net taxable income (Record p. 27). Another way of figuring, which arrives at the same result, is to take as the March 1st, 1913 value of the Company's property interest through its leases of the mines, 71.9% of the net royalty the Company received on each ton of ore, which 71.9% of the net royalty of 30c per ton which the Company received on the Hudson Mine or lease amounts to 21.57c per ton, and 71.9% of the net royalty of 45c per ton on the Perkins Mine or lease amounts to 32.355c per ton for that property (Record p. 26). This net property interest value was over and above the entire royalties the respondent Company had to pay the fee owners.

These amounts the court found were the reasonable allowances for depletion contemplated by the statutes which the tax-

payer Alworth-Stephens Company was entitled to deduct from its *gross income*, to arrive at its *net taxable income* (Record p. 27). The court also found that said allowances, plus all allowances made in figuring the federal taxes paid in previous years, did not equal the fair market value of respondent's property interest in the properties as of March 1st, 1913, and this allowance did not exceed the fair market value in the mine of the ore mined and sold during the year 1917, which value the court finds was in excess of the full amount of both the net royalties received by the Alworth-Stephens Company plus the total amount of royalties going to the fee owners (Record p. 27, paragraphs 13 and 14).

The computation of the tax made by the lower court is set forth in Exhibit A attached to the decree (Record pp. 29 and 30). The Department has never claimed that this computation was in any respect incorrect, if the Alworth-Stephens Company was entitled to any deduction whatever for depletion. In fact, the District Court adopted the contentions of the Department as to the rate of discount, to find the March 1st, 1913, value, and allowed a 9% discount or risk rate as against the contention of the Alworth-Stephens Company that it should not be more than 6%, and if the rate had been 6% we would have been entitled to a considerably larger deduction. As it was figured, however, it will be seen that the excess profits tax on a part of the income amounted to 60% thereof, in addition to the income tax of 6%. This computation shows that the total gross receipts of the Company (after paying the fee owners their royalty) for the year 1917 amounted to $77,505.98, from which is deducted for depletion 71.9% on account of the March 1st, 1913, value of the company's leasehold or property interest for the returns of 1917, amounting to $55,726.80, leaving a net taxable income for that year of $21,779.18 (Record pp. 28 to 30). On this last amount the income tax amounted to $735.70 and the excess war profits tax to $9,517.51, or a total of $10,253.21, which was the exact amount the Alworth-Stephens Company originally paid the Government on the return made by it. This Exhibit A also

shows an excess payment to the Government of $17,128.44, which was the exact amount of the additional payment the Government demanded and which the Company paid under protest, and for which judgment was entered. (pp. 28 to 30).

While it is true that the Alworth-Stephens Company in its original tax return for 1917 computed its tax on a different theory, yet the amount that it computed and paid was exactly the amount which the court found that it should have paid, and the question here is whether the finding and conclusion of the District Court was correct, and, as the District Court says in its findings and order for judgment (Record p. 29, par. 18):

> "It is deemed unnecessary and tending to confuse rather than clarify the issues to set forth in detail the contentions or claims which were from time to time made by both the government and the plaintiff."

Suffice it to say that the Alworth Stephens Company in its original return in 1917 computed and paid its tax under Section 209 of the Act of October 3, 1917, and the Revenue Department assessed it an additional $17,128.44 under Section 210 of that act, which is the one which provides that in case the Department is unable in any case satisfactorily to determine invested capital, the Department shall determine the tax simply by arbitrarily comparing the taxpayer in question with some other taxpayers (not designated) in the same line of business and assess the tax accordingly. We had the matter up through long correspondence with the Internal Revenue Department, and, as appears by this correspondence, the Department, through Commissioner D. C. Roper and his Chief Assistant, P. S. Talbert, agreed with the justice and equity of our claim and an order for refund was made pursuant to these interviews in an amount several thousand dollars larger than the judgment herein gives us, and was approved, but stated that as this allowance would involve a modification of the regulations then existing, it must

receive the approval of the Solicitor of the Department (see Record pp. 171 to 177). It also appears that on our interviewing him he was entirely satisfied with the justice of our claim, but wished a brief, showing whether there was any court decision preventing the allowance, and assured us in effect that if there was not he would approve the allowance and modification of the regulation. On the writer's return to Duluth and within a comparatively few days, such a brief was furnished, which showed conclusively that there was no such decision. The *Weiss* case, hereinafter mentioned, had not at that time been decided by the District Court, but it was decided by the District Court during this correspondence in favor of a refund (Record p. 174). However, the Solicitor's Department finally decided not to give its approval to the refund which had been recommended by Mr. Roper and Mr. Talbert, (p. 176) undoubtedly as Mr. Miller, who was then the Solicitor for the Department, found that he was about to retire from office and did not wish to commit his successor to a modification of the regulations which he and Commissioner Roper and his Chief Assistant, P. S. Talbert, all frankly admitted worked great injustice and hardship. (pp. 86 and 87). The italics in this brief are as a rule our own in quotations.

THE STATUTES

For the convenience of the court in considering the questions here discussed, we here assemble the provisions of the Federal tax law from its inception in 1909 down to the present, as relating to the deductions allowed from *gross income* to arrive at the *net taxable income*, and showing the changes in the law made by the different statutes or amendments.

Act of August 5th, 1909.
36 *Statutes*, 113.

This statute provided, in Section 38, for deductions *from gross income* of the following:

"First: All ordinary and necessary expenses actually paid within the year out of income in the maintenance and operation of its business and properties, including all charges, such as rentals or franchise payments, required to be made as a condition to the continued use or possession of property.

Second: All losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation of property, if any, and in the case of insurance companies, the sums other than dividends paid within the year on policy and annuity contracts and the net addition, if any, required by law to be made within the year to reserve funds.

Third: Interest actually paid, etc.

Fourth: All sums paid for taxes, etc.

Fifth: All amounts received by it within the year as dividends upon stock of other corporations, etc.

Act of October 3, 1913,
38 *Statutes*, 166, 167.

This act provided that there should be allowed as deductions from the income of corporations the following:

First: All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property.

Second: All losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation by use, wear and tear of property, if any; *and in the case of mines a reasonable allowance for depletion of ores and all other natural deposits, not to exceed five per centum of the gross value*

at the mine of the output for the year for which the computation is made.

Act of September 8, 1916,
39 Statutes at Large, 759.

This act, which is the one here involved, provided for deductions *from gross income* of corporations as follows:

Sec. 12 (a). In the case of a corporation, joint stock company or association, or insurance company, organized in the United States, such *net income* shall be ascertained by deducting from the *gross amount* of its income received within the year from all sources:—

First: All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity.

Second: All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade; (a) in the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (b) *in the case of mines, a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof which has been mined and sold during the year for which the return and computation are made,* such reasonable allowance to be made in case of both (a) and (b) under rules and regulations to be prescribed by the Secretary of the Treasury: *Provided, that* when the allowance authorized in (a) and (b) shall equal the capital originally invested, *or in case of purchase made prior to March 1st, 1913, the fair market value as of that date,* no further allowance shall be made.

In Section 2 of the Act, defining income, subdivision (c) (39 Statutes at Large, 758) reads as follows:

> (c) For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, *acquired before March 1st, 1913, the fair market price or value of such property as of March 1st, 1913, shall be the basis for determining the amount of such gain derived.*

Act of October 3, 1917,
40 Statutes at Large, 303 to 307.

This act did not change the act of September 8th, 1916, so far as relates to the matter of depletion, here under consideration, but this act provided for a war excess profits tax, and the sections relating thereto which will be later principally considered are Section 201, page 303, Section 203, page 304, Section 209, page 307, and Section 210, page 307.

War Revenue Act of 1918,
Volume 40, page 1077 et seq.

This law provides, in Section 234, subdivision (9), page 1078, for deductions from gross income as follows:

> "In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost, including cost of development not otherwise deducted: Provided, That in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that date: Provided further, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913 and not acquired as the result of purchase of a proven tract or lease, where the fair market value

of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner with the approval of the Secretary. *In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee.*"

II.

ARGUMENT

The lessee, as well as the lessor, owned a valuable property interest in the mine, by reason of which under the express terms of the Revenue Act in force in 1917, *the lessee, as well as the lessor, was entitled to a deduction from its gross income, of a reasonable allowance for exhaustion of its leasehold interest by reason of depletion of the mine, in arriving at its net taxable income, but the lessor's and the lessee's deductions were not to exceed the total market value in the mine of the product thereof which was mined and sold during the year, provided that where the interests were acquired prior to March* 1, 1913, *the total allowance so made should not exceed the fair market value in the mine as of that date, the respective deductions of the lessor and lessee to be allowed according to the value of their respective interests in the propert yas lessor and lessee.*

If the above proposition is correct, the judgment herein and the decisions of the District and Circuit Court of Appeals are correct.

At the outset of our argument, let us make perfectly clear some things that we do not claim.

(1) We admit, for the purpose of argument, that royalties

received by our Company were gross income under the decisions of this court.

(2) We do not claim that a lessee is entitled to deduction *as against a fee owner and lessor* or exclusive of such lessor. We admit and claim that they are both entitled to a deduction for depletion according to the value of their respective interests in the property as represented by fee and lease, as such interest existed on March 1st, 1913, where those interests were purchased or acquired prior to that time.

(3) We do not claim that the respondent, as lessee, was technically the purchaser of the legal title to the ore in place in the mine. But the lessee did have a vested property interest and estate in the mine, through its lease, and exclusive right to mine and remove the ore and convert it into cash, and its property interest and value in the mine were gradually exhausted by depletion, through the mining and selling of the product of the mine during the year, exactly as in the case of the fee owner.

Both lessor and lessee are taxpayers. The statute in force in 1917 is above quoted from the Act of September 8, 1916, 39 Statutes at Large, 759, and the portion thereof here important is, as above quoted:

> "Section 12 (a). In the case of a corporation * * * *such net income* shall be ascertained by deducting from the *gross amount of its income* received within the year from all sources:
>
> "Second—all losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade * * * (b) *in the case of mines, a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof which has been mined and sold during the year for which the return and computation are made.* * * * *Provided, that when the allowance authorized in* (a) *and*

(b) *shall equal the capital originally invested, or in case of purchase made prior to March* 1st, 1913, *the fair market value as of that date, no further allowance shall be made.*"

Also Section 2, subdivision (c), of the Act, above quoted (39 Statutes at Large 758):

> "For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, *acquired before March* 1*st*, 1913, *the fair market price or value of such property as of March* 1*st*, 1913, *shall be the basis for determining the amount of such gain derived.*"

Nowhere in the statute as it then stood were the words "lessor" and "lessee" used. What the statute covered was the taxpayer and his income and his deductions from income. In the proper application of the law there never can arise a conflict between a lessor and lessee, for when the property was acquired before March 1, 1913, each deducts for depletion from his *gross income* simply the March 1st, 1913 value of *his interest*, through the fee or through his lease, in the product for the tax year in question, and the sum total of both deductions, of course, can never exceed the March 1st, 1913 value of the property, for that value is made up of the value of lessor's and lessee's interest therein where they owned those interests on March 1st, 1913.

We make the above statement at the outset because in previous briefs and arguments before the Department and in the courts below the Department has contended that to allow deduction for depletion to a *lessee* of a mine according to *his interest* would in some mysterious manner deprive the *lessor* of his deduction according to *his interest*. In fact, in the trial brief submitted in the District Court, the Department summed up its

argument upon this point at the end of its brief under the heading "Conclusion" as follows:

> "It is submitted that the plaintiff, a lessee of mining property, is not entitled to claim a deduction for depletion, *as against the fee owner*, under the provisions of Section 12 (a) of the Revenue Act of 1916."

Also, in the assignments of error made by the Department in the Circuit Court of Appeals we find the following under the Fourth assignment of error:

> "and that the statutory deduction for depletion cannot be credited twice—once to the fee owners and again to the lessee; that such a deduction for depletion belonged of right to the fee owners and the Alworth-Stephens Company was not entitled to the deduction for depletion."

The arguments of the Department evidently misled the Circuit Court of Appeals of the Sixth Circuit in the case of *Weiss vs. Mohawk Mining Company*, 264 Fed. 502, hereinafter more fully discussed, because the last sentence of the decision of that court on re-argument was:

> "that the statutory reduction for 'depletion' cannot be twice credited, once to the fee owner, and once to the lessee; and that the exemption belongs of right to the fee owner."

This position taken by the Department is a fundamental error. It must necessarily be erroneous to argue that allowing depletion to a lessor according to his interest and to a lessee according to his interest would result in crediting the same depletion twice. This position is *absolutely unsound*, because allowing depletion to the fee owner *according to his interest* in

the property in no manner conflicts with the allowance of depletion to the lessee *according to his interest* in the property, nor does so doing result in crediting the same depletion allowance twice, for the simple reason that the depletion allowances *are not the same.* It is true that as to property acquired before March 1, 1913, the sum of the two depletion allowances should not and in practice could not exceed the March 1st, 1913 value of the property.

On analysis, the matter would seem to be as plain as the fact that 2 and 2 make 4. For the statute in terms makes a reasonable allowance for depletion, but provides that no further allowance shall be made when the allowances shall have equalled, in the case of a purchase made prior to March 1st, 1913, the fair market value as of that date. Now, if a fee owning lessor were alone concerned and it were found that his March 1st, 1913 value equalled 4, then the Department would allow him reasonable depletion until the figure 4 was reached. But, the Department says, if on the other hand it be found that on March 1st, 1913, the value of the fee owner's interest in the same property was equal to 2 and the value of the lessee's interest in the property through his leasehold is equal to 2, then we will allow the fee owner a deduction up to the extent of 2 only, but we will allow the lessee, who owns the other interest in the property, no deduction whatsoever.

Our contention is simply that where the value of the ownership is divided equally through the fee and a lease, then the lessor is entitled to depletion up to the extent of 2 and the lessee is entitled to depletion up to the extent of 2, and the sum total is 4, which is exactly the same depletion the Department would have allowed the fee owner in case there had been no lease, or in case the rate of royalty under the lease was so high that the lessee's interest in the lease was of no value.

As a matter of fact, there is absolutely no conflict between a lessor and a lessee as to their respective deductions. They are both entitled to deductions for depletion according to the

March 1st, 1913 value of their respective interests in the property, and no more and no less—the lessor according to the value of his interest as modified and lessened by the lease which he has granted, and the lessee according to the value of his lease, which, in the present case, was even greater than the value of the fee interest, because in the present case the fee owner would never receive more than 30c per ton royalty, while the Alworth-Stephens Company, lessee from the fee owner and sub-lessor to the operating companies, would receive net on one mine 30c per ton and on the other 45c per ton.

It was certain, as found by the court, that the ore would all be taken out by the operating companies within seven years from March 1st, 1913, and it was so taken. It follows as the night the day that the sum total of the two deductions for depletion could not equal more than the March 1st, 1913 value of the mine. The Alworth-Stephens Sompany as lessee and sub-lessor could never take depletion to a greater extent than the March 1st, 1913 value of its leasehold property interest. The fee owner could never take depletion to a greater extent than the March 1st, 1913 value of the fee owner's interest in the property as that value was modified and limited by the lease which had been granted to the Alworth-Stephens Company.

The Department has always admitted and claimed that a fee owing lessor was entitled to his deduction according to his interest *as modified by the lessee's interest*, but denies the right to any deduction in 1917 for depletion for a lessee. Yet they are both owners of property interests in the mine and both are taxpayers under the law, and the law in force in 1917 never used the words "lessor" or "lessee" at all, and spoke only of the deductions to which a taxpayer was entitled from the *gross amount* of his income in arriving at his *net taxable income*. Neither does the law in force in 1917 make any distinction as to the character of the property right or estate owned by the taxpayer and exhausted because of its employment in business.

Judge Sanborn noted carefully the language of the statute. Before construing it, he said: (Record page 199)

> "When one first reads this provision, no doubt or uncertainty as to the parties to whom it authorizes these allowances for depletion to be made occurs to the ordinary mind. The suggestion does not arise that this is a grant to the owners of the fee titles to mines or that lessees and all others having property interests in them are excepted from the grant."

In construing the statute, he said:

> "The plain, clear and reasonable meaning of the statute seems to be that the reasonable allowance for depletion in case of a mine is to be made to everyone whose property right and interest therein has been depleted by the extraction and disposition of the product thereof which has been mined and sold during the year for which the return and computation are made."

Shortly after the passage of the act here in question, the Revenue Department issued a document known as Form A-M-MS, entitled "Schedule for Depletion, 1909 to 1917", and in this document says:

> "Lessor. Under the Act of 1909 a lessor is entitled to no deduction for depletion. Under the Act of 1913 and under the Act of 1916 a lessor is permitted a depletion allowance, which is computed like that of an operating owner, except that where a mine was leased before March 1, 1913, the allowance for depletion in favor of the lessor is based, not on the fair market value of the ore or material in place as of March 1, 1913, *but on the lessor's interest therein on that date.*"

The same document says:

> "Lessees. As mining leases are held not to convey the mineral deposits in place but only the privilege of entering upon the premises and mining and removing such deposits, *under none of the Acts of* 1909, 1913 *or* 1916 *is a lessee entitled to deduction from income on account of depletion.*"

By this ruling the Department arbitrarily, without any justice or equity or valid reason at all, attempted so to construe the 1916 law as not only to limit the lessor's right to depletion to *his interest in the property as of March* 1*st*, 1913, *but also to deprive the lessee of any right to depletion at all.* In other words the lessor was held to be entitled to relief according to *his interest in the property as modified by the interest of the lessee,* but the lessee was allowed no right of depletion, even though the lessor's right thereto had been modified and limited because of the lessee's interest.

A lessee has a vested property interest and right in the mine covered by its lease.

Practically all of the mines in Minnesota, from which comes upwards of 50% of all the iron ore used in the United States, are operated under leases. The largest mines are stripped of the overburden by the lessees. There are several of the largest mines in Minnesota which had been entirely stripped of overburden prior to March 1, 1913 by the lessees, and where the leasehold interest on that date had at lease five times the market value of the interest of the lessors in the property on the same date.

Judge Sanborn says:

> "It is common knowledge that in the case of mines

> the property rights and interests therein and the incomes derived therefrom by lessees and others than those who own the titles to the mines are much more valuable than the rights and interests of such owners." (Record page 200).

Mining leases form the basis of industrial operations of great extent, involving the investment of large sums of money and the employment of thousands of men.

The mining leases owned by the Alworth-Stephens Company constituted on March 1, 1913 its property and its only property, which property was exhausted and rendered less valuable year by year by depletion through mining and sale of the iron ore in the mine. There can be absolutely no question that such mining leases grant an interest or estate in the property or that the lessee has a vested property interest and estate therein. Section 6652 of the Statutes of Minnesota of 1913 is as follows:

> "Estates in lands are divided into estates of inheritance, estates for life, estates for years, and estates at will and by sufferance."

In Section 5396, Minnesota Statutes of 1913, in the chapter on Eminent Domain, the legislature has defined the meaning of the word "owner" as follows:

> "and the word 'owner' as so used shall extend to all persons interested in such property as proprietors, *tenants*, encumbrancers or otherwise."

Subdivision 9 of Section 9412 of the Statutes of Minnesota of 1913, giving definition of words used in the Minnesota statutes, reads:

"The words 'land', 'lands', 'realty', and 'real estate' shall include lands, tenements, and hereditaments, and all rights thereto and interests therein."

Section 7002 of the Minnesota Statutes of 1913 reads:

"No estate or interest in lands, other than leases for a term not exceeding one year, nor any trust or power over or concerning lands, or in any manner relating thereto, shall hereafter be created, granted, assigned, surrendered, or declared, unless by act or operation of law, or by deed or conveyance in writing, subscribed by the parties", etc.

Section 7003 of the Minnesota Statutes of 1913 reads:

"Every contract for the leasing for a longer period than one year or for the sale of any lands, or any interest in lands ,shall be void unless the contract, or some note or memorandum thereof, expressing the consideration, is in writing and subscribed by the party by whom the lease or sale is to be made", etc.

Section 7035 of the Statutes reads:

"Whoever performs labor or furnishes any skill, material or machinery in or about the opening or working of any mine, at the request of the owner thereof or of the lessee of such owner, or of any contractor of either, shall have a lien for the value thereof *upon the interest of such owner or lessee, as the case may be, in said mine* and its appurtenances, which lien may be asserted and enforced as in this chapter prescribed in respect *to other liens upon real estate.*"

In *Olson vs. Oneida Mines Co.*, 153 Minn. 80, the Minnesota court held that this statute confined liens for services and material furnished *a lessee* in opening and operating a mine *to the interest of the lessee therein*, clearly recognizing the property interest of a lessee in such mine.

In *In re Emerson's Homestead*, 58 Minn. 450, the Supreme Court held, in line with former decisions, that a person was entitled to a homestead in a ten-year lease, and this in hotel property.

In *Minnesota Debenture Co. vs. Dean*, 85 Minn. 473, the

Minnesota court approves the definition by Bouvier of an estate as follows:

> "The quantity of interest which a person has,—from absolute ownership down to naked possession."

and holds that the word "estate" at common law is most comprehensive and that it has not been limited in use in Minnesota, either by courts or legislative enactment.

Leasehold estates have been recognized by innumerable court decisions which it is unnecessary here to cite, except that it may be worth while to note the decision of the Circuit Court of Appeals for the Eighth Circuit in *Ewart v. Robinson*, 289 Fed. 740, where the lessee under an oil lease brought ejectment to secure possession of the leased premises. This case involved directly the character of the estate granted by the lease. Judge Kenyon examined and reviewed the Minnesota cases dealing with mineral leases of iron ore land. He also reviewed the decisions of this court in the *Sargent Land Company* and *Biwabik* cases hereinafter referred to, and held that,—

> "While the lease did not amount to a conveyance of the oil or gas or mineral in the ground, it did amount to a conveyance of an interest in the land, and was not a mere license." (Page 750).

The court therefore affirmed judgment in favor of the plaintiff and held that the lessee was entitled to maintain an action of ejectment.

Judge Sanborn in the opinion in this case in the court below, says,—

> "The property rights of these lessees were as absolute, as indefeasible, as enforceable at law and in equity and more valuable than the property rights and interests of the owners of the titles to the mines, of the lessors of the plain-

tiff, which interests were limited by the terms of the leases." (Page 198).

It is of the utmost importance to note, to begin with, the broad general language contained in the Revenue Act of 1916, Section 12, subdivision second, as follows:

> "All losses actually sustained and charged off for the year and not compensated by insurance or otherwise, including a reasonable allowance for the *exhaustion*, wear and tear of property arising out of its use or employment in the business or trade."

This general provision clearly contemplates that deductions shall be made including a reasonable allowance for the exhaustion of all property which is used or employed in trade or business and is gradually consumed and exhausted by such use. The provision relating to mines (paragraph b) is one of the subdivisions of this general provision of the law.

The leaseholds here involved, covering the Perkins and Hudson Mines, not only represent property rights in the fullest sense, but in fact constituted the entire property which the Company owned on March 1, 1913, all of which was consumed and exhausted by the mining and sale of the ore.

At the Hudson Mine, the evidence shows conclusively that on March 1, 1913 the mine was stripped and ready for shipping, and was worth upwards of $1.00 per ton for all of the ore therein. (Rec. page 39). It was absolutely certain that the sublessee would mine out all of the ore within seven years. The fee owners of the Hudson Mine could never get more than 30c per ton in royalty therefrom. The Alworth-Stephens Company as lessee and sub-lessor would likewise net 30c per ton, as it had sub-leased at 60c per ton. Under the contention made by the Government, the fee owner would be entitled to claim de-

pletion on this thirty-cent property interest in this mine, while the Alworth-Stephens Company would be denied the right to take depletion on its thirty-cent interest therein, although both interests were of exactly equal market value on March 1, 1913.

When ore was mined and sold there occurred a depletion in the value of the respondent's property interest just as much as in the value of the fee holder's property interest.

In the case of the Perkins Mine, the property interest of the Alworth-Stephens Company therein was greater than that of the lessor, who is the fee owner, yet the construction contended for by the Government would grant to the lessor the right of depletion on his thirty-cent interest, but deny such right of depletion to the lessee on its forty-five cent interest, although both interests combined were less than the total value of the mine on March 1, 1913. On principle, therefore, it would clearly appear that the lessee is a smuch entitled to claim depletion as the lessor.

We had many interviews with heads of divisions in the Internal Revenue Department and officials, including Mr. Roper, (R. pages 86 and 173), and also had extensive correspondence with reference to this claim, and as we stated on the record (p. 86) we have yet to find a single individual who maintained there was any justice or equity in the ruling of the Department.

The Department adopted the foregoing quoted regulation discriminating between lessors and lessees of mines and in the early interpretation of the law adopted certain regulations against allowances to tax payers in other wasting industries and properties but has gradually modified the rules in these other cases.

Regulations 33 (Revised) Article 170, with reference to oil and gas properties, which regulations were based upon paragraph (a) of subdivision second of Section 12 of the law of 1916, likewise denied to lessees the right of depletion, except to the extent of the amount paid in cash for the lease. As pointed out by Judge Sanborn in his opinion (Rec. p. 201) and as herein-

after more fully set forth this regulation was abandoned on August 22, 1922 by Treasury Decision No. 3386, and a new regulation adopted permitting the lessee to take depletion on oil and gas properties on the basis of the fair market value of his interest as of March 1, 1913.

Under Regulations 33 (Revised) Article 174, it was expressly provided that no deduction should be made in the case of patents, except to the extent of the actual cost thereof. Under Regulations 45, Article 163, such deductions may now be made for all intangibles, examples of which as given in the Regulation, are "patents and copyrights, licenses and franchises."

Strong confirmation of the right of the taxpayer to make this deduction and of the justice of allowing the same is found in the opinion of the United States Board of Tax Appeals in the Appeal of Grosvenor Atterbury, decided December 11, 1924, (Docket No. 195).

This Appeal was taken from a determination by the Commissioner of a deficiency in the income taxes paid by the appellant for the years 1917 to 1920 inclusive. The appellant contended "that the Commissioner erred in holding that a lessee is not entitled under the Revenue Acts of 1916, 1917, 1918 and 1921, to an allowance for depreciation based on the value of his lease as of March 1, 1913, if acquired prior thereto.

The taxpayer on May 1, 1903, acquired for business purposes a leasehold on premises in New York City for the sum of $33,804.80, which then had a term of life of nineteen years. On March 1, 1913, the leasehold had a conceded value of $58,500.00. We quote from the opinion of the Board as follows:

> "The Commissioner contends that the depreciation claimed by the taxpayer is not a proper deduction within the meaning of Section 214 (a) (8) of the Revenue Act of 1918, or Section 214 (a) (8) of the Revenue Act of 1921. In making this contention, the Commissioner asserts that

he has consistently held that a lessee is not entitled to an allowance for depreciation based upon the value of a lease as of March 1, 1913, if acquired prior thereto, but, if a leasehold was acquired for business purposes, the purchaser has been allowed as a deduction in his income tax return an aliquot part of the purchase price each year, based on the number of years the lease has to run. This deduction has not been considered an exhaustion of property within the meaning of Section 214 (a) (8) of the Revenue Acts of 1918 and 1921, but has been allowed upon the theory that the amount paid for a lease constitutes advance rental and that, as such, it would ordinarily be a business expense, and could be deducted in annual installments over the period of life of the lease.

"The provisions of Section 5 (a) (7) of the Revenue Acts of 1916 and 1917 relating to allowance of deductions in computing net income are identical in language and read as follows:

> " 'A reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade.'

"Section 214 (a) (8) of the Revenue Act of 1918 was changed in language to read as follows:

> " 'A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.'

"Section 214 (a) (8) of the Revenue Act of 1921 contains added language so that it reads:

> " 'A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. In the case of such property acquired before March 1, 1913, this deduction shall be computed upon the basis of its fair market price or value as of March 1, 1913.'

"It should be noted that, in *all four* of the sections above cited, the acts provide for *deductions* to be *allowed* and not for depreciation. In the light of this language, the attempt of the Commissioner to distinguish between *deduction* and *depreciation* in making *allowances* on leaseholds seems to be without reason and illogical. The statutes do not use the word *depreciation*. The term *exhaus-*

tion, used in *all four* sections, properly describes the reduction in the remaining life of a leasehold as it approaches, year by year, its termination.

"It should also be noted that all four of the sections quoted use the word *property*, without limitation, restriction, or definition of that term. *A leasehold has been long recognized in law as property.* It answers all the requirements of the simple definition which describes property as "the exclusive right to possess, enjoy and dispose of a thing'. *Certainly a leasehold of the character here involved is one of the most important elements of property used in trade or business*, because without the right to occupy the business premises the taxpayer could conduct no business nor could he derive a gain from a sale thereof upon which a tax could be imposed. We, therefore, cannot escape the conclusion that the taxpayer is entitled to take a deduction for each of the years involved for *exhaustion* of his leasehold."

In this opinion the Board expressly quotes and construes the Revenue Acts of 1916 and 1917, as well as the later laws, and calls attention to the fact that the statutes use the term "exhaustion" rather than the word "depreciation" which is used by the Commissioner. It is expressly held that a leasehold is a *property interest*, that it not only may be employed in business but is one of the most important elements of property used in trade or business, and that the conclusion cannot be avoided that a taxpayer is entitled to take a deduction for the exhaustion of his leasehold.

In the early regulations the Department drew a distinction between a deduction based upon the amount actually paid for or invested in a lease and its fair market value March 1, 1913. Even in the case of mining leases, it was provided in Regulations 33 (Revised) Article 171, that a lessee could take a depletion deduction based upon the amount of capital invested in the lease, but the right of the lessee was limited to such deductions, although the lessor was permitted to base his deduction on the

fair market value of his interest. This limitation was a plain injustice against the lessee.

By the decisions above quoted the Board of Tax Appeals is now definitely committed to the proposition that a deduction must also be made for the exhaustion of the value of the leasehold as of March 1, 1913. The action of the Department in thus step by step modifying and correcting the unjust and inequitable ruling made with reference to the holders of leases and similar rights under the laws of 1916 and 1917, constitutes of itself a strong and persuasive reason for the application of the same rule to mining leases.

With the single exception of the case of *Weiss v. Mohawk Mining Company*, 264 Fed. 502, which case, as we shall presently point out, really did not consider the questions decided by Judge Sanborn in the court below, and was evidently influenced by what we believe to have been a misunderstanding of the effect of the decision of this court in the Biwabik case, there is no case opposed to our contention here.

PETITIONER'S BRIEF

Practically all of our brief, including the foregoing and what hereinafter follows from our heading of "The Decided Cases", was in type before the Department's brief was received, but we deem this a proper place to reply directly to certain contentions in the Department's brief.

The position is taken in the Department's brief that only the fee owner can have depletion, because he is technically the owner of the ore in place.

But the statute allows a reasonable deduction from gross income for the exhaustion of property, and then in express terms,

so far as our case is concerned, defines the property to which this deduction from gross income applies, as follows:

> "(b) In the case of *mines* a reasonable allowance for depletion *thereof*, not to exceed the market value in the mine of the product thereof which has been mined and sold during the year."

Thus, by the express provision of the law, the "mine" is the property on account of which the deduction from gross income is made. The deduction from gross income is measured by the market value in the mine of the product mined and sold during the year, and is allowed to the taxpayer who has the gross income derived from the depletion of the mine through the mining and sale of its product, and who thereby actually sustains the diminution in the value of his property interest by the mining and selling of the product.

The lessees interest in the mine constitutes property of the highest character. It is commonly bought and sold, may be mortgaged for the security of money, may be levied upon and taken by process of law, and passes by inheritance, and is a property interest and estate as clearly recognized under the law as the fee interest.

The contention of the Department that only a fee owner can have an allowance for depletion because he is technically the owner of the ore in place, ignores the fact that the lessee owns a valuable property interest and estate in the mine, which is the property on account of which the allowance is made; that his ownership represents a property right and interest in the ore, which is a part of the mine, even though that property interest is not the technical legal title; that the mining and sale of this product of the mine depletes the value of the mine as a whole and the value of the leasehold property interest in exactly the same way as it depletes the value of the

fee interest; that the statute permits allowances for depletion by mining and sale of the product up to the total March 1st, 1913, market value; that to accord to the taxpayer the total March 1st, 1913, value as an allowance, which the statute expressly grants, *it is necessary to add together the value of the property interests of both the lessor and the lessee in the mine as of that date;* that the statute makes no exclusion of this full March 1st, 1913, value of the property, nor does it make any exclusion of any taxpayer from obtaining his part of such allowance, for the statute says, "the fair market price or value of such property as of March 1st, 1913, shall be the basis for determining the amount of such gain derived", and that when the allowance shall equal "the fair market value as of that date, no further allowance shall be made"; that the statute is presumed to treat all taxpayers alike who actually sustain a depletion of a March 1st, 1913, property value; and that, as pointed out by Judge Sanborn in the absence of an express exclusion of some taxpayer or interest, it must be presumed that the statute covered all those whose property interest in the mine are so affected, and certainly, as the mine is gradually depleted and exhausted by mining and selling the ore, the property interest of all who have rights and estates therein are proportionately exhausted and depleted and they are proportionately entitled to an allowance therefor from the gross receipts which arise out thereof. (Page 199).

This contention of the Department ignores the decisions of this court, such as *Stratton's Independence, Von Baumbach vs. Sargent Land Company,* and other cases, to the effect that the mine is the property which is exhausted through the mining and sale of the ore and on account of which the allowance is made. It is not the physical ore which the statute says shall be deducted from the gross income, but an allowance not exceeding the market value thereof, which is to be deducted from the gross income, and that gross income is created and comes into existence by reason of the very fact that the value of the mine is depleted by the mining and sale

of the very substance of the property. The Department's entire argument is built on a fundamental error that the allowance is limited to the technical legal owner of the ore in place. The law nowhere so states. On the contrary, the right is given to every taxpayer who actually sustains a loss by the depletion and exhaustion of his property interest in the mine, and is not confined to the owner of any particular property interest therein.

To illustrate, suppose there is a chattel mortgage under which the technical legal title to the chattel is in the mortgagee, and that this chattel constitutes his only security, as the mortgagor is not financially responsible, and that the amount of the loan secured is exactly one-half the value of the chattel. Then suppose that the chattel is absolutely destroyed. Would the Department say that the mortgagee, because he had the technical legal title, was the only one who could deduct any loss from his gross income, or could not the mortgagor also deduct from his gross income the value of his property interest and right in the destroyed property? Does the statute say anything about technical legal title? As Judge Sanborn points out, the allowance to the taxpayer who sustains a diminution in the value of his property interest should be as broad as the statute which requires the taxpayer to pay an income tax, and as this Court has pointed out in *Gould vs. Gould*, 245 U. S. 151, and other cases, a taxing statute will be construed in favor of the taxpayer and will not, by implication, be so construed as to require the payment of a tax unless its terms expressly so require.

The Department says the word "depletion" refers to "the emptying of something physical". Suppose it does. It is not the physical ore which is allowed or depleted from income, but "a reasonable allowance for depletion thereof (that is, the mine), not to exceed the market value in the mine of the product thereof" that is deducted from gross income. Every time a mine is depleted by the physical removal of a ton of ore the value of the fee owner's interest and of the lessee's interest therein is proportionately lessened or depleted. The lessee does not, as the De-

partment contends, claim any allowance because of the depletion of the fee owner's property right, but solely and only because of the depletion of his own property interest and estate in the mine. Both interests go to make up the total property interest which the statute allows to be depleted. It requires both interests to total the full March 1st, 1913, value of the mine, assuming, of course, that the royalty is low enough, as it was proved in this case to be, so that the lessee's property interest had a real, substantial value as of that date. Where both interests in the mine as of that date had an actual value, to make a proportionate allowance for depletion according to the respective proportionate values in the whole mine is not in one case more than in the other making an allowance for using up another's property interest and right. The royalties received by the fee owner in 1917, constituting his income from the mine, in part represented the March 1st, 1913, value of his interest in the mine. The royalties or return received by the lessee in 1917, which constituted his income, in part represented the March 1st, 1913, value of his interest in the mine. In the case of both the part representing the March 1st, 1913, value of the respective interests in the mine is the "allowance for depletion thereof" which the statute grants the taxpayer. From their respective gross incomes from the mine, the statute entitles each to his reasonable allowance for depletion, to find his net taxable income.

The Department says that by the removal of the ore there was a loss to the fee owner but a gain to the lessee, and that "the lessee has neither more nor less ore by working the lease". Passing the inconsistency of these statements, the fee owner and the lessee each had a thirty cents per ton property interest in the Hudson Mine, each of which, on March 1st, 1913, let us assume, was worth $100,000. The ore was all mined out before 1919 and the leases surrendered because of no more value. The fee owner still had the technical legal title to the land, which was of no value, and the lessee had nothing. Each had lost, by mining and removal of the product, the March 1st, 1913, value of his in-

terest in the mine, which was the depletion contemplated by the statute. That March 1st, 1913, value had been converted into cash as to each, in exactly the same amount and at exactly the same time, and in exactly the same way, and when the physical mining was completed there was nothing of value left to either, except that the fee owner continued to have the technical legal no-value title to the mined-out land. How, then, can it be said, as the Department contends, that the lessee had gained and the fee owner lost? Things equal to the same thing are equal to each other.

Certainly the operators of mines in Minnesota, who have expended millions of dollars in development, in sole reliance upon their property rights, to produce ore from these properties, would be surprised to learn that as ore is mined and removed from these properties there has been no lessening or exhaustion of their interest in these properties, or of their values, and would be quite gratified if they could convince themselves that the Department's statement is true, that they had just as much after the ore was gone as they had before. It is, of course, not true, as the Department suggests ,that ownership in the mine is confined to the technical legal title, but the fact is that the two estates of lessor and lessee, taken together, represent the entire ownership in the property. Judge Sanborn, with his long experience and knowledge of mining matters, fully appreciated the relation of lessor and lessee, and justly overruled the inaccurate and technical claims made by the Department.

The Department also claims that the fact that the Revenue Act of 1918 added an additional sentence, as follows: "In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee", indicates that Congress did not consider that mining lessees had the right to take depletion under the previous laws. The sentence added in the 1918 act does not purport to create any new right. This paragraph in the law contains on its face conclusive evidence of the purpose of Congress to provide for the apportionment of an

existing right or remedy. Plainly, unless the lessee had a property interest in the mine, he could have no right under either the Law of 1916 or the Law of 1918 to an allowance for depletion. This vested right existed in 1917 in exactly the same way that it existed under the law of 1918, and was affected in precisely the same manner by mining operations.

The Department refers to a report of the Committee on Ways and Means, submitting the Revenue Act of 1918, to the effect that the new law corrected an inequality of the then present law, by providing for an equitable apportionment of the depletion allowance between lessor and lessee. We have examined the Congressional Record and find that this is the only reference to this clause that appears in any report made on this measure, and that there was absolutely no discussion of this clause on the floor of the House or Senate. The complete explanation of this reference is found, however, in what occurred at the meetings conducted by the Committee on Ways and Means in June, 1918. Representatives of taxpayers interested in mining and in the production of oil appeared before the Committee and claimed that as the law stood in 1917 it was broad enought to cover an allowance to lessees as well as to fee owners, but that in view of the mis-construction which had been placed upon the law by the Treasury Department, the new Revenue Act should be clarified, so as not to leave any question about the right of mining lessees to their share in a reasonable allowance for depletion. See statements filed and testimony taken, as appears on pages 523 to 538, page 545, and pages 916 to 918 of the Special Volume of Reports on the Hearings on the Revenue Act of 1918 before the Ways and Means Committee. Those so appearing therefore proposed the language which was finally adopted in the Revenue Act of 1918, and which is plainly declaratory of the rights of lessees as they existed under the law in force in 1917. There would have been no occasion to propose this addition if it had not been for the misconstruction which the Department had placed upon this law, and this was then stated to the Committee. This clause was therefore merely intended to set at rest any possible misinter-

pretation by the Department of the law, rather than to correct any actual inequality if properly interpreted, and it was undoubtedly assumed during these discussions that the addition of this clause would be considered by the Department a construction of the meaning of the prior act, and that the Department would reverse its previous holdings, as it finally did in August, 1922, as to oil and gas leases and as it probably would have done at the same time or earlier as to mining lessees, had it not then been for the decision in *Mohawk Mining Company vs. Weiss*, hereinafter more fully considered.

The fact that the Department in its brief makes only slight reference to the opinion of Judge Sanborn in this case, and makes no attempt directly to answer his reasoning, is especially significant in view of the extremely narrow and technical construction which the Department places upon the law and the rights of a mining lessee.

On the question here for decision, the illustrations of the Department as to a contract existing on March 1st, 1913, for mining or shipping ore, are not in point or analagous. Such contracts would be simply personal contracts, which would give the contractor no kind of property interest in the mine.

But a leasehold does give the lessee a vested property interest, estate and right in the mining property, which, as above pointed out, Judge Sanborn says was "as absolute, as indefeasible, as enforcible at law and in equity, and more valuable than the property rights and interests of the owners of the titles to the mines, of the lessors of the plaintiff, which interests were limited by the terms of the leases." Therefore, it may be true that under the particular statute here in qestion, involving an allowance for depletion, a contractor who had a mere personal mining or hauling contract would not be entitled to an allowance for depletion as such. But we need not here consider whether, if such a contractor had such a contract, of a well-known, established value as of March 1st, 1913, he might be entitled to de-

duction from his gross income as such March 1st, 1913, value was consumed, either under this statute or under some other, or on some theory. It would seem, however, that the Department has and does allow deductions under most such circumstances, for, as pointed out elsewhere in this brief, it allows deduction on account of the March 1st, 1913, value of valuable advertising contracts, for the value of intangible property, on account of patents, copyrights, licenses and franchises, on account of good will, and, under the above mentioned ruling of the Committee on Appeals and Review, handed down December 8th, 1924, a long-time leasehold which had a well-defined March 1st, 1913 value, but which did not, as does a mining lease, involve the actual consumption and sale and disposal of the very substance constituting the value of the real estate, as does the sale of the ore in a mine. In fact the Department, in all cases of ascertainable March 1st, 1913 values which taxpayers have, allows a deduction, so far as we are aware, *except only in the single case of a lessee of a mine.*

The Department's brief says that the statute contemplates a deduction shall be allowed only in the case of a purchase prior to March 1st, 1913, and that a purchase can only apply to a fee owner. The word "purchase" as used in this act is clearly intended to cover the acquisition of property by any lawful means whatsoever. As hereinbefore quoted, 39 Statutes at Large, 758, reads as follows:

> "(c) For the purpose of ascertaining the gain derived by a sale or other disposition of property, real, personal or mixed, *acquired* before March 1st, 1913, the fair market price or value of such property as of March 1st, 1913, shall be the basis for determining the amount of such gain derived."

It is under this section that the figuring is done, and unquestionably the word "purchase' 'in the depletion section was used in the same sense as the word "acquired' 'in this section—that

is, the acquisition of property by any lawful means whatever. If the narrow meaning of "bargain" and "sell" were to be given the statute, it would exclude any fee owner who had acquired his property by gift or inheritance prior to 1913. No such meaning or effect was ever intended or has been placed upon it by the Treasury Department.

This claim of the Department is conclusively disposed of by the definition given by this Court to the word "purchase" in *Waskey vs. Hammer*, 223 U. S. 85, where the question arose whether one who staked out a mining claim had purchased an interest in the land, and this Court said:

> "The term 'purchase' is inclusive of the various modes of acquiring title to given rights in public lands under the general laws regulating their disposal."

It was there held that acquisition was a purchase.

In *United States vs. Whipple Hardware Co.*, 191 Fed. 945, the court says:

> "The word 'purchase' must be taken in its legal sense, which includes all modes of acquisition except that of descent."

See also *Buchser vs. Morss*, 196 Fed. 577; *United States vs. Beaty*, 198 Fed. 284, at 286.

In the General Statutes of Minnesota of 1913, Section 6813 of the Chapter relating to conveyances of real estate, the word "purchase" is defined as follows:

> "The word 'purchase' as used in this chapter, shall embrace every person to whom any estate or interest in real estate is conveyed for a valuable consideration, and also ev-

ery assignee of a mortgage, lease or other conditional estate."

But in any event, the Alworth-Stephens Company did purchase its interest in the property as early as 1909, because the option for leases which it held were given for a valuable consideration (p. 103) and required the Alworth-Stephens Company to do certain exploratory work (p. 105), and the leases themselves (pp. 124 and 145) required the payment of taxes on the whole of the mines and performing many other obligations. Clearly this constituted a purchase of the interest of the Alworth-Stephens Company in the mines prior to March 1st, 1913, just as clearly as a fee owner would have purchased his interest if he took a deed of the premises, either clear of incumbrances or subject to leases.

THE DECIDED CASES

This Court has several times passed upon questions arising under the 1909 Law, which law did not in terms provide for depletion, as did the Acts of September 8th, 1916, and October 3rd, 1917. The leading cases passed upon by this Court as to the 1909 Law are:

Von Baumbach vs. Sargent Land Company, 242 U. S. 503;
United States vs. Biwabik Mining Co., 247 U. S. 116,
Stanton vs. Baltic Mining Co., 240 U. S. 103.

The *Sargent Land Company* case arose under the 1909 law. This was a case involving royalties received by the fee owners. It was held by the court that the royalties received were in the nature of rentals and that they constituted income to the *owner of the fee.* The court says:

"The decisive question in this case is whether the payments made as so-called royalties amount to income so as to bring such payments within the scope of the corporation tax act of 1909."

The court, having held that the royalties constituted income within the meaning of the law, also held that the law provided no deduction for depletion therefrom, and that therefore the whole amount of the royalties was taxable to the fee owner following the principle laid down in *Stratton's Independence vs. Howbert*, 231 U. S. 399. The decision was expressly limited to the 1909 law, which law, (Act of August 5, 1909, 36 Statutes 113), as seen in the quotation as to deductions hereinbefore set forth in this brief, did not contain any provision whatsoever for allowance for "depletion" and did not use the word and did not mention mines. The court based its decision upon the proposition that *depreciation* should be construed in the ordinary sense as growing out of the use or wear and tear of property, and that it did not cover "depletion" or the exhaustion of ore from property. Be it borne in mind that that decision related to royalties received by a *fee owner*. The court says:

"It may be admitted that a fair argument arises from equitable considerations that, owing to the nature of mining property, an allowance in assessing taxes upon income should be made for the removal of the ore deposits from time to time. *Congress recognized this fact in passing the income tax section* of the Tariff Act (Sec. II, 38 Stat. at L. 166, 167, chap. 16, Comp. Stat, 1913, sections 6319-6322), when it permitted 'a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business, not to exceed, in the case of mines, *five per centum of the gross value at the mine of the output for the year for which the computation is made*'; and in the Income Tax Law of September 8, 1916, a reasonable allowance is made in the cases of mines for depletion thereof '*not to exceed the market value in the mine of the product thereof which has been mined and sold during the*

year for which the return and computation are made.' These provisions were not in the Act of 1909, and as we have said, we think that Congress, in that act, used the term 'depreciation' in its ordinary and usual significance. We therefore reach the conclusion that no allowance can be made of the character contended for as an item of depreciation."

It will be observed that in the above case the court squarely bases its decision upon the proposition that the 1909 *Act of Congress made no express provision for deduction for depletion from income, but points out that the later acts, which were not involved in that case, had done so and so had taken care of the equitable considerations justifying such deductions.*

In the case of *United States vs. Biwabik Mining Company*, 247 U. S. 116, 62 L. Ed. 1017, this Court had before it the case of a lessee, as distinguished from a fee owner in the *Sargent Land Company* case. This case also arose under the 1909 law. This Court followed the *Sargent Land Company* case, *making absolutely no distinction between income or royalty received by a lessor and income or royalty or value belonging to a lessee*, but held that in both instances they were taxable under the 1909 law, simply because that law made no express allowance for the deduction of depletion from income.

In *Stanton vs. Baltic Mining Company*, 240 U. S. 103, 60 L. Ed. 546, this Court recognized the right to deduct five per cent of the gross value at the mine of the output for the year in question, *under the* 1913 *law*. Here the court recognized and held constitutional the law permitting a five per cent deduction of the value at the mouth of the mine *as depletion*, and held that the law was constitutional and valid, even though the depletion so allowed was not as much as might be allowed other companies in other lines of business. The court made no distinction between a lessor and a lessee. The 1913 law was the first one that used the words "allowance for depletion of ores".

The foregoing are the principal cases which have any bearing upon this question, decided by this Court. It will be noted from the foregoing that the following things are true:

(1) That the only cases in which this Court has held that there shall be no depletion or deduction on account of the removal of ore *are cases arising under the* 1909 *law*, and that in those cases it was so held because there was no express provision allowing the deduction, and that all returns from royalties or rentals were taxable as income, *but in those cases under the* 1909 *law the court makes absolutely no distinction between royalties and rentals received by a lessor and by a lessee.* In the *Sargent Land Company* case it held that all the royalties received by a lessor were income. In the *Biwabik* case it held that royalties or their equivalent, received by a lessee, were income. In both cases no deduction was allowed because the 1909 law provided for no deduction, but in the *Sargent Land Company* case the court pointed out that the 1913 and 1916 law had expressly provided for deductions for depletion.

(2) This Court has recognized, under the law of 1913, that a deduction of five per cent of the value of the output at the mouth of the mine is a proper deduction, because the law expressly provided for depletion to that extent, this holding being in the *Stanton vs. Baltic Mining Company* case, but it made no distinction as between lessor and lessee.

(3) This Court has therefore held in three leading cases: (a) that royalties of a fee owner are income and under the 1909 law he is entitled to no deduction, as in the *Sargent* case; (b) that a sub-lessor's royalties, or the equivalent value of his returns in mining, constitute income and he is entitled to no deduction under the 1909 law, as in the *Biwabik* case; (c) that under the 1913 law a taxpayer is entitled to a five per cent deduction for depletion, because the law expressly so provides, as in the *Stanton* case, but makes no distinction between a lessor and a lessee; and (d) this Court has pointed out, in the *Sargent* case, that Congress has changed the 1909 law by the Act of September 8th, 1916, in expressly allowing a deduction from income, by quoting the language of that law:

"in the case of mines, a reasonable allowance for depletion thereof, not to exceed the market value at the mine of the product thereof which has been mined and sold during the year for which the return and computation are made, such reasonable allowance to be made * * * in the case of purchase made prior to March 1, 1913, the fair market value as of that date * * *."

There is nothing in the 1916 act in force in 1917 which makes any distinction between the right of a fee owner or of an intermediate lessee to claim a deduction from gross income to the extent or value of his right or interest in the property as it existed March 1st, 1913. The exhaustion of the ore body *is a depletion* of his property right and interest in the mine, of his leasehold value, just as much as it is depletion of the fee owner's property right and interest in the property, proportionate to the March 1st, 1913 value of the respective property interests. Of course, if the lessee were paying so high a royalty that he had no March 1st, 1913 value in his lease, then he would be entitled to no deduction. It is only to the extent of whatever value he then may have, in the mine through his lease that he is entitled to claim a deduction. *There is absolutely no sound foundation for the department's contention that an intermediate lessee has no property interest or right in the mine.* The fact is, the property interest in the mines was acquired by the intermediate lessee years before the Act of Congress took effect and this property intrest and property value existed on the 1st of March, 1913, just as potently as did that of the fee owner.

This Court has made no distinction in its holdings between a fee owner and a lessee. In the case of both, under the 1909 law, it has held that the whole rental or royalties are taxable as income without deduction, *because* the law made no express provision for allowance for depletion. In the *Biwabik Mining Company* case the contention of the company was that the lessee was more entitled to deduction for depreciation than the fee owner, but the court decided that he was no more so entitled than

the fee owner, but it *did not hold* that he was less entitled than was the fee owner, but placed them both upon exactly the same basis. The lessor's right to allowance for depletion to the extent of his right and interest in the property is just as strong and no stronger than the lessee's right. They are both interested in the property. They must each figure the value of their interest as modified by the interest of the other. Each is entitled to allowance for depletion to the extent of the value of his interest as it existed on the 1st of March, 1913, and the sum of the two depletions do not and never could equal more than the total value of the mine on that date. The lessor, if he receives royalties in instalments, therefore, must pay the tax upon the total amount which he receives over the value of his interest as it existed on the 1st of March, 1913, and the lessee, likewise, if he receives royalties through a sub-lease, concededly must pay the tax on what he receives over the value of his property interest as it existed on March 1st, 1913.

WEISS vs. MOHAWK MINING COMPANY, 264 Fed. 502.

The single case relied upon by the Department in the argument in the court below was the above entitled case and this is the single case it relies on here. The decision of Judge Westenhaver in the District Court in that case was in favor of the Mining Company. We submit that the decision of the Circuit Court of Appeals in that case did not really consider the point for which we here contend. In the original opinion filed in that case the court seemed to base its decision on the theory that the nature of a lessee's interest in the mine was such as to preclude its claim for depletion. Any such claim is fully answered by the opinion of Judge Sanborn and by our argument herein. In the opinion on reargument the court seems to base its decision on the ground that there was a conflict between lessor and lessee as to which should have depletion and that the exemption for deple-

tion belonged to the fee owner because it was assumed only one of them could have an allowance. In the decision filed on the petition for rehearing, the court says:

> "We think the substantial principles established by the decisions are that both the royalty received by the fee owner and the sums received by the operating lessee above the cost of operation are income; *that the statutory reduction for 'depletion' cannot be twice credited, once to the fee owner, and once to the lessee; and that the exemption belongs of right to the fee owner.*"

This quotation alone shows that the court never could have understood the proposition for which we here contend. We make absolutely no contention that the lessee *should* be allowed a depletion and that the lessor or fee owner *should not*. Under the statute they are both entitled to depletion according to their respective interests, both, however, not to exceed the value on March 1st, 1913.

Applied to the concrete facts of the present case and illustrating it by the Hudson Mine, the fee owner here had leased its property to the Alworth-Stephens Company at 30c per ton royalty. The Alworth-Stephens Company had sub-leased the same property for 60c per ton royalty, 30c of which it had to pay to the fee owner. The property would be mined out inside of seven years, so that the fee owner had a property interest in this mine of exactly the same value on March 1st, 1913, as the Alworth-Stephens Company. Therefore, on the basis of the finding of the lower court, the fee owner is entitled to allowance for depletion to the extent of 71.9% of the 30c per ton, equal to 21.57c per ton, and the lessee was entitled to the same depletion. The sum of the two depletions would therefore be approximately 43c per ton, while the evidence shows that the March 1st, 1913 value, as well, of course, as the 1917 value, was upwards of $1.00 per ton (Record pp. 39, 40).

Applied to the Perkins Mine, the fee owner had leased at 30c per ton. On this mine too he would be entitled to a deduction of 71.9% on every dollar that he received in royalties, or 21.57c per ton. The Alworth-Stephens Company had sub-leased at 75c per ton, leaving a net royalty to it of 45c per ton. It would on this mine also be entitled to a deduction of 71.9c on every dollar in royalties that it received. As its royalty was 45c per ton, it would be entitled to a deduction of 32.355c per ton as the March 1st, 1913 value of its property interest in the mine. The sum of the fee owner's and lessee's deductions would be about 54c per ton. On this mine also the value in 1917, as well as in 1913, stripped as the mine was, was upwards of $1.00 per ton. (Record pp. 50 and 51).

The depletion which is given the Alworth-Stephens Company by this judgment in no manner conflicts with any possible depletion allowance that could be claimed by the fee owners of these two properties who had only an interest represented by 30c per ton royalties, which was the most they could receive, and even if the Government should allow them the whole 30c per ton as the March 1st, 1913 value (which, of course, the Government would not do), still there was more than ample value left to grant the Alworth-Stephens Company all the depletion allowance given by this judgment, for on the Hudson Mine the depletion allowed by the judgment was 21.57 per ton and on the Perkins property 32.355c per ton, while the March 1st, 1913 value was found by the court to be upwards of 75c per ton (Record p. 26). The Alworth-Stephens net total royalties for 1917 were $77,505.98, and the depletion allowed was $55,726.88, which, as shown by Exhibit A attached to the findings of the court (Record p. 29), was exactly the March 1st, 1913 value of our leasehold interest on a per ton basis. Judge Sanborn says, in the opinion below:

> "The allowance in this case has been sedulously limited to the market value as of March 1, 1913, of the *individ-*

ual property right and interest of the plaintiff in the two mines." (Record page 202).

The court, in the *Weiss* case, therefore, did not at all appreciate our contention, inasmuch as it considered that a depletion could be allowed to only one of the parties interested in the property and as allowing to one would exclude the other, it therefore concluded that the fee owner only, could have a depletion allowance. If the fee owner in our case, instead of leasing to us, had leased direct to our sub-lessees, the Hudson at 60c per ton and the Perkins at 75c per ton, then even the Department does not claim but that the lessor alone would have been entitled to depletion on both of these properties, to the full extent above pointed out that we claim both the lessor and ourselves as sublessor would be entitled to deplete. Can it make any difference to the government or to the rights of the parties that the ownership of the property has been divided, by reason of the intermediate lease to the Alworth-Stephens Company? Under the Government's contention, if there had been no intermediate lessee it would have allowed a deduction to the lessor alone on the Hudson property to the extent of *twice* 21.57c per ton, or a total of 43.14c per ton, and it would have allowed on the Perkins property a deduction to the extent of 71.9% of 75c or 53.925c per ton, which is the sum total of the deductions that both lessor and lessee are entitled to under the above illustration. The Department takes the wholly untenable position that where there is a lessor and an intermediate lessee, the lessor is entitled to depletion *only to the extent of his interest as modified by the interest of the lessee,* but that the lessee cannot have depletion at all and that therefore the Government will collect, as applied to the present case, more than twice as much tax, because of the intervention of an intermediate lessee, than it would had there had been no such divided ownership.

Furthermore, the decision in the *Weiss* case seems to have been based simply upon the proposition that because *under the*

1909*Law* this Court decided in the *Biwabik* case that a lessee was not entitled to claim its capital assets had been diminished by the removal of ore, therefore depletion could not be claimed. The court seems to have overlooked the fact that this court, in the *Sargent Land Company* case, had held exactly the same thing as to a fee owner, to-wit: that he could not claim that by the removal of ore his capital assets had been diminished. That court seems entirely to have overlooked the contention which we here make, that both these decisions, as to a fee owner and as to a lessee, were made under the 1909 law, and that in both of these cases this Court held that royalties received or their equivalent were income as to each and as the statute had made no provision for depletion allowance no deduction on that account could be claimed. In the case now before the court, however, the 1916 law did make an express provision for depletion and did not, in terms or otherwise, limit it to a lessor. It simply provided that the taxpayer might deduct from his *gross income* a certain amount for depletion in arriving at his *net taxable income*. Not the slightest distinction was made between a lessor and a lessee.

It is only necessary here that this court apply the statutory provisions of the 1916 law which it cited in the above quoted decision in the *Sargent* case and which it there stated were absent from the 1909 law which it was there construing.

It may seem from the reasoning in the *Weiss* case that the court reached its conclusion because it considered that within the Supreme Court decisions a taxpayer could not deduct as for a return of capital assets, therefore he could take no allowance at all. The error of this reasoning is in assuming that the subject of capital assets has anything to do with the question. We admit that, under the decisions, royalties received by a lessee, as well as those received by a lessor, are not capital assets, but that they are income. But we assert that the 1916 law expressly permits deduction for depletion of the March 1st, 1913 value of the taxpayer's interest in the mine which is included in and rep-

resented by those royalties *from the gross amount of the income* before arriving at the *net taxable income*. The decision in the *Biwabik* case, which the court in the *Weiss* case seemed to think was binding upon it, made absolutely no distinction between a lessor and a lessee as to what was income. The decision in the *Weiss* case, without any foundation or justification, assumes that the Supreme Court in the *Biwabik* case made such a distinction, when in fact it did no such thing.

As Judge Sanborn well points out in the opinion below, the Circuit Court of the Sixth Circuit in the *Weiss* case seemed to find difficulty in allowing depletion, because it considered that "depletion" in the 1916 Act was not different from "depreciation" under the 1909 Act, and as to this Judge Sanborn says:

> "But if there were no substantial distinction as applied to a mine between that depreciation or allowance for capital assets consumed which was sought by mine owners under the earlier acts, and that depletion which was expressly allowed by the acts of 1916, there remains, nevertheless, this distinction and difference between the right to the allowance sought under the earlier acts and the right to the allowance sought in this case and in the Weiss case. Under the earlier acts the right to the allowance sought *was not expressly granted by Congress; under the act of* 1916, *the right to the allowance sought is expressly granted. The difference is great.*" (Record page203).

The 1909 Act, which was considered in the *Biwabik* case, by which case the court in the Sixth Circuit considered itself bound, did not use the word "depletion" at all and did not, in the section in question, refer to "mines" at all, while the 1916 Act did use the word "depletion" and did in that connection expressly refer to "mines", as this court so well pointed out in the *Sargent* case.

There is not the slightest thing in the language of the Act of Congress itself which authorizes an allowance for depletion

in favor of a lessor any more than in favor of a lessee. They are both owners of rights in the property—the original lessor of the fee, limited and reduced by the lease—the lessee of the lease, which is the value which the fee owner has parted with and conveyed away. They both have an estate in the property. There is nothing in the language of the statute which justifies a distinction based upon the technical legal title to the ore in place. The act is dealing with the taxpayer's taxable income. In the *Weiss* case the court seemed to think that it was governed by the *Biwabik* case because in that case it was held that no deduction under the 1909 law was allowable from royalty income as a capital asset of a lessee. But how can the right to an allowance be made to depend upon that fact and the allowance for depletion of ores be given to a fee owner when no deduction was allowable from royalty income as a capital asset of the fee owner, as it was determined in the *Sargent* case? The change from the 1909 law was made because of the injustice which that law had created, but there is no ground for the supposition that Congress was influenced by the claims of fee owners and not equally by the claims of lessees. It must be believed that Congress, as nearly as possible, intended to put all taxpayers on an equality with reference to their property interests and deductions.

The writ of ceriorari in the *Weiss* or *Mohawk* case was denied by this Court (254 U. S. 637). On what ground does not appear, as no opinion was filed, but we are morally certain that it was because it could not have been clear to this Court that there was anything else involved than whether the Mohawk Mining Company was entitled to a deduction on account of capital assets, and the real question now before this Court, namely, whether the statute by its express language entitled a lessee as well as a lessor to depletion really was not deemed presented. The Department brief says the petition for a writ of certiorari was denied and "The Mohawk case was therefore considered on its merits by this Court." This

is directly contrary to the holding of this court which is that the denial of such a petition is in no sense a passing upon the merits as held in *Hamilton vs. Wolf*, 240 U. S. 251.

The statute itself does not justify and there is no decision of this Court which justifies any distinction between the right of a lessor and a lessee to claim depletion. The only distinction which has been made is the arbitrary, unjust and impractical ruling of the Internal Revenue Department. The former Commissioner of Internal Revenue, his Chief Assistant, and the Solicitor of the Department have all acknowledged to the writer of this brief that this ruling was inequitable and unjust and ought to be modified, (see Record pages 86 and 173 to 175). If it were simply a question whether royalties constitute capital assets or not, we concede that this Court has decided that they do not, but this Court has recognized, in the *Sargent* case, that the taxpayer under the 1916 law is entitled to a deduction *from gross income* of his 1913 property value, represented by his right to receive royalties. But it has not decided that a lessee is less entitled to the depletion expressly given by statute than the lessor. Every consideration of common sense and justice requires that they be equally allowed a depletion, according to their respective interests, each as modified by the interests of the other. It would be difficult to find a more unjust and unreasonable construction of any law than the Department adopted here. We cannot conceive how such a ruling can exist, except on the theory that it was made when the law was new, when the Department officers were uncertain as to its meaning in many particulars, when war conditions prevailed and everything was in a jumble, and the officers felt it to be the safer course to resolve every question of construction in favor of the Government, so as to derive as much tax as possible and to absolve themselves from possible criticism in making any construction which by any possibility later might be thought to be too favorable to the tax payer. The continuance of such construction can only be accounted for because someone originally made it and no one

since, in the Department, has, in common parlance, "had the nerve" to overrule or modify it.

The Department contends that under the decisions the relations between a fee owner and a lessee are to be worked out on the principle of landlord and tenant. This we do not and never have disputed. It was undoubtedly because of this fact that this Court, in the *Sargent Land Company* case, held that all royalties, even in the hands of a fee owner, were income, but it does not at all follow from this fact that a lessee is less entitled to take the statutory deduction allowance for depletion than is a fee owner. The only substantial value of an iron ore property is the ore in it. When that ore is gone, its value is gone. Where the value of the fee owner's and the lessee's interest in the property is unquestionably the same as of March 1st, 1913, as in the case of the Hudson Mine, can any reason be suggested why the removal of a ton of ore does not deplete the lessee's interest as well as that of the fee owner? Depletion means simply exhaustion or emptying out. And where the value of the fee owner's and lessee's interest was equal on March 1st, 1913, every time a ton of ore is mined the lessee's interest or value was exhausted, or emptied out, or depleted, exactly in the same way as that of the fee owner.

Nearly all iron ore mines in Minnesota are operated under leases. These leases, many of them taken in the early days and the properties stripped by lessees, were on March 1st, 1913 worth several times the value of the fee. Leases, as in the present case, usually run for fifty years, and sometimes for much longer, some as long as ninety-nine years.

It is wholly immaterial whether the Alworth-Stephens Company was or was not technically the owner of the ore in place. It owned the leaseholds on these mines, which were, as the court finds property interests (page 26) and more valuable than the fee. When the ore was mined out, the value of its leasehold property interest was exhausted or emptied out or depleted, exactly in the same way as that of the fee owner and, as it happens

in this particular instance, to an even larger extent in dollars and cents than the value of the fee interests.

If the Alworth-Stephens Company on or after March 1st, 1913, had purchased its lease from someone else, paying therefor in cash 71.9% of the net royalties that were to be received from the sub-lessees under it, even the Department would have allowed it depletion as the ore was mined, up to that amount. And yet the law expressly provided, "in the case of purchase made prior to March 1st, 1913, the fair market value as of that date" should be allowed as depletion. It certainly should make no difference to the Government and no difference in common sense whether the Alworth-Stephens Company owned a lease of a certain value on March 1st, 1913, or on that date purchased and paid that amount for a lease. In either event it should be entitled to the allowance. And yet the Department would allow it to deplete or get back its value in case it had purchased on that date, but would deprive it of the same right if it had purchased a day or more prior thereto.

The Treasury Department has by its rulings recognized the right to a deduction because of exhaustion of intangible property through its use in business (Regulations 45, Art. 163, as modified by T. D. 2929, Regulations 62, Art. 163); also in the case of patents, copyrights, licenses and franchises (Regulations 62, Art. 167); also for the exhaustion of good will (Ruling No. 15-19-445, Adv. Bd. Rec. 44, 1 c. b. 133; Ruling No. 17-20-84, Off. Dec. 472); also for contract for advertising (Ruling No. 1-9-115, T. D. 122), also for the March 1, 1913 value of a lease of New York real estate as decided by the Committee on Appeals and Review December 8, 1924, as hereinbefore quoted, and generally recognizes the right to deduction of the March 1st, 1913 value which the taxpayer had *in all cases now, except in the case of a lessee of a mine.*

RECENT CHANGE IN DEPARTMENT'S RULING.

Under date of August 22, 1922, the Revenue Department over the signature of A. W. Mellon, Secretary of the Treasury, and D. H. Blair, Commisioner of Internal Revenue, completely reversed the previous holding of the Department with reference to oil leases as relating to this very question *and applying to* 1917.

By reference to the statute of September 8th, 1916, (hereinbefore quoted) which was in force so far as this point is concerned in 1917, as the act of October 3rd, 1917 did not modify it in this respect, it will be found that oil and gas leases are treated under the same section and same subdivision as mining leases. The statute to which we refer is found in 39 Statutes at Large, page 759, and provides, in Section 12 (a), as to a corporation, for deduction from the gross amount of its income as follows:

> "Second: All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade; (a) in the case of oil and gas wells a reasonable allowance for actual reduction in flow and production to be ascertained not by the flush flow, but by the settled production or regular flow; (b) in the case of mines, a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof which has been mined or sold during the year for which the return and computation are made, such reasonable allowance to be made in case of both (a) and (b) under rules and regulations to be prescribed by the Secretary of the Treasury: Provided, that when the allowance authorized in (a) and (b) shall equal the capital originally invested, or in case of purchase made prior to March 1st, 1913, the fair market value as of that date, no further allowance shall be made."

It will therefore be seen that oil and gas wells are treated in exactly the same way, as to the taxpayer's interest therein, that mines are treated. The word "lessor" or "lessee" is not used with reference to oil or gas wells, any more than it is used with reference to mines.

Up until August 22, 1922, Article 170 of the Internal Revenue Department's Regulations 33 (Revised) was in force, parts of which section, in the language of the Regulations, stated that the taxpayer was entitled "to deduct from gross income—

> 'A reasonable allowance * * * for actual reduction in flow and production, * * * provided that when the allowance authorized * * * shall equal the capital originally invested, or in case of purchase made prior to March 1, 1913, the fair market value as of that date, no further allowance shall be made.'
>
> "The essence of this provision of law is that the owner or operator of this character of property shall secure through an aggregate of annual depletion deductions, the return of the amount of capital actually invested, or an amount not in excess of the fair market value as of March 1, 1913, of the properties owned prior to that date.
>
> "For the purpose of determining the amount of capital to be returned through annual deductions, operators may be divided into two classes, (a) operators who own the fee, and (b) operators who own a lease or leases.
>
> "In the case of the operating *fee owner*, the amount returnable *through depletion deductions is the fair market value o fthe property* (*exclusive of the cost of physical property*), *as of March* 1, 1913, *if acquired prior to that date*, or the actual cost of the property if acquired subsequent to that date, plus, in either case, the cost of development (other than the cost of physical property incident to such development) up to the point at which the income from the developed territory equals or exceeds the deductible expenses.
>
> *"In the case of a lessee, the capital thus to be returned is the amount paid in cash or its equivalent as a bonus or otherwise by the lessee for the lease, plus also expenses in-*

curred in developing the property (exclusive of physical property) prior to the receipt of income therefrom sufficient to meet all deductible expenses, after which time as to both owner and lessee, such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the drilling of wells and further development of the property, may, at the option of the operator, be deducted as an operating expense or charged to capital account."

By Treasury Decision No. 3386, under date of August 22, 1922, the Department issued a regulation entitled as follows:

"To collectors of internal revenue and others concerned:

"Article 170 of Regulations 33 (revised) is hereby amended to read as follows:

" 'Art. 170, Secs. 5 and 12 of the act of September 8, 1916 as amended by the act of October 3, 1917 authorizes, etc.' "

Here follows, without any substantial change and almost word for word, all of the above quoted part of the original regulation 170 until it comes to the last paragraph above quoted in italics, relating to a lessee, and in place of that paragraph Article 170 of the Regulations is now made to read as follows:

"In the case of a lessee, the capital thus to be returned *is the fair market value of the lessee's interest as of March* 1, 1913, *if acquired prior to that date*, or the amount paid in cash or its equivalent as a bonus or otherwise by the lessee for the lease if acquired on or after that date, plus, in either case, all expenses incurred in deevloping the property (exclusive of physical property) prior to the receipt of income therefrom sufficient to meet all deductible expenses, after which time, as to both owner and lessee, such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the drilling of wells and further development of the property, may, at the option of the operator, be

deducted as an operating expense or charged to capital account. *The value of the equities of lessor and lessee shall be computed separately, but when determined as of the same basic date, shall together never exceed the value at that date of the property in fee simple. By 'basic date' is meant March* 1, 1913, *in case o facquisition prior to that date, or the date of acquisition where it occurred on or after that date."*

By comparison of the section just quoted with the last section, relating to a lessee, of the regulations as they stood prior to August 22, 1922, it will be seen that the Department, as to leases of oil and gas properties, has now completely reversed itself as applying to 1917 on the very point now under consideration by this Court, as to mining properties. The regulations formerly provided, with reference to oil and gas properties, as to 1917, just as they did as to other mining properties, that a lessor was entitled to depletion according to his March 1, 1913 interest, but that *a lessee of oil and gas properties was entitled to no depletion* on account of the March 1, 1913 value of his lease interest but only to the extent he might have paid a bonus for the leases. The department has likewise always ruled as to 1917 that a mining lessee could deplete to the extent he had paid a bonus for his lease but has wholly deprived him of the right to deplete the March 1, 1913 value thereof except to the extent he had paid a bonus therefor. But it allowed a fee owner to deplete the March 1, 1913 value of his property, regardless of whether he had paid much or nothing for his interest. By this change in the regulations a lessee of oil and gas properties is now entitled to depletion according to his March 1, 1913 interest, in exactly the same way as a lessor. Evidently the Department, as to oil and gas properties, now finds no conflict between the interests of a lessor and a lessee, for it has very easily provided:

"The value of the equities of lessor and lessee shall be computed separately, but when determined as of the same

basic date, shall together never exceed the value at that date of the property in fee simple."

That is exactly what we have always contended for and what we contended for before the Department and before the court below, and this contention has now been recognized by the Department *as to the law in force in* 1917 and the taxes of oil and gas lessors and lessees under that law.

If this regulation is properly modified as to oil and gas leases there is no earthly reason why the Department regulation and ruling should not be equally modified as to other mining leases. There can be no valid distinction between an oil lease and a mining lease.

The Department has evidently been driven by the injustice of its former rulings to allow an oil lessee a deduction from gross income for depletion. It should clearly be compelled, by the injustice of its previous rulings, to reverse them and allow a mining lessee a like deduction. Why it did not do so as to mining lessees at the same time it did as to oil lessees is a mystery to us, unless it is simply awaiting the impetus thereto to be given by this Court. We trust that if that impetus is necessary it will be given by this Court and as a result thereof the Department will modify its regulations and not continue to insist on its unjust position as to other lessees as it has with us.

The Department says in its brief that it changed its ruling on oil and gas leases and allowed a depletion, because it understood certain of the decisions of this Court to hold "that there was no ownership of the oil or gas in place under the ownership of the land".

First, may it be noted that the decisions to which the Department refers were rendered long before it made its first ruling and regulation under the 1917 law, which it allowed to stand until late in 1922.

Second, if the right to an allowance for depletion rests upon a technical legal title to the substance in place, as the Department now contends, then if there is no ownership of the substance in place, as the Department says as to oil and gas, it must follow that *neither* lessor nor lessee would be entitled to an allowance for depletion. But the Department now, inconsistently with its argument, allows depletion to both lessor and lessee in oil and gas properties, as shown by the amended Article 170 of Regulations 33, as above quoted.

Third, if, as the Department suggests in the next to the last paragraph of its brief, it understood this Court to hold that "ownership of the surface did not give ownership of the oil and gas in place, but that it belonged to the lessee (or other party) who reduced it to possession", then why, to be consistent with its present contention, did it not allow a depletion to a *lessee* of oil and gas wells and *deny* depletion to the *lessor?* Instead, it did allow depletion to both, just as we contend it should do as to mines. The Department can only become consistent in this respect when it makes an allowance for depletion to a lessor and lessee of mines, just as it allows depletion to both lessors and lessees of oil and gas properties, from the 1917 income.

In the petition for the writ in this case the Department states that many returns of mining lessees have been audited under the regulation laid down by the Department and that if this decision is affirmed it will necessitate refunds in considerable amounts. This certainly should have no bearing upon the case. There are many mining lessees' returns for the year 1917 which have not been settled by adjustment with the Department, and the Department has pursued its course with full knowledge of the contentions of taxpayers and in the teeth of the decisions of the District Court in Ohio, the District Court in Minnesota, and the Circuit Court of Appeals for the Eighth Circuit, and we know that many still unsettled cases are awaiting adjustment depending upon this Court's final ruling.

III.

Even should the Court decide that the foregoing propositions are incorrect, still the judgment should be affirmed, since in 1917 the Alworth-Stephens Company had no invested capital or only a nominal capital and properly was assessable under Section 209 of the Act of September 8, 1916, as amended by the Act of October 3, 1917, in force for the year 1917, which would result in at least as large a judgment in its favor.

The foregoing discussion as to depletion relates, of course, generally to the case of any mining lessee. But on the facts applying to this particular Company, the result in dollars and cents is at least as favorable if, as we contend, it falls within the class of companies designated by Section 209 of the Act of September 8, 1916, as amended by the Act of October 3, 1917, in force for the year 1917. This section related to war excess profits tax and is found in 40 Statutes at Large, page 303, and reads as follows:

> "Sec. 209. That in the case of a trade or business having no invested capital or not more than a nominal capital there shall be levied, assessed, collected and paid, in addition to the taxes under existing law and under this Act, in lieu of the tax imposed by section 201, a tax equivalent to eight per centum of the net income of such trade or business in excess of the following deductions: In the case of a domestic corporation $3,000, and in the case of a domestic partnership or a citizen or resident of the United States $6,000; in the case of all other trade or business, no deduction."

By the Act of October 3, 1917, Title I of the Act of September 8, 1916, was amended by adding to Part III thereof new sections numbered from 27 to 31, and Section 29 reads as follows:

"Sec. 29. That in assessing income tax the net income embraced in the return shall also be credited with the amount of any excess profits tax imposed by Act of Congress and assessed for the same calendar or fiscal year upon the taxpayer, and, in the case of a member of a partnership, with his proportionate share of such excess profits tax imposed upon the partnership."

Article 860 of Regulations 45, which applied in 1917, issued by the Department, reads as follows:

"Article 860. *Impairment of Capital.* Capital or surplus actually paid in is not required to be reduced because of an impairment of capital in the nature of an operating deficit, *except where there has been, directly or indirectly, a liquidation or return of their investment to the stockholders, in which case full effect must be given to any liquidation of the original capital.*"

Upon the basis of Section 209 and even without allowing *any deduction* from gross income for depletion, the tax of the Alworth-Stephens Company for 1917 would be figured as follows:

Income		$77,505.98
Deduct excess profits tax payable under Section 209, 8% of income in excess of $3,000.00, 8% on $74,505.98, or		5,960.48
Balance of income		$71,545.50
6% on $71,545.50	$4,292.73	
Add excess profits tax	5,960.48	
Total Tax		$10,253.21

The Alworth-Stephens Company made its return for 1917 and paid its tax on the above basis. By an exceedingly curious coincidence, using the 9% discount or risk basis for depletion value, which the lower court adopted, the amount of the tax

which the Alworth-Stephens Company should have paid happens to be exactly the above figure to a cent, which it did pay when it made its return on the basis of Section 209, although the 9% risk basis was decided upon by the District Court in telling us to draw findings without any regard to where the discount rate would land in actual figures, but either method of figuring, either on the depletion basis which the court adopted, or under Section 209, applying to companies with no invested capital or not more than a nominal capital, arrives at the same tax to a cent.

The findings of fact of the lower court, upon which the judgment was based, set out in full the facts upon which the judgment may be sustained, if this Court should deem that the Alworth-Stephens Company should be assessed under Section 209 as a company having no invested capital or not more than a nominal capital. Par. 14 of the findings (Record p. 27) is as follows:

> "14. That the total amount of the net royalties which the plaintiff received from said properties for the year 1917 and which were left and belonged to it after it had paid therefrom all royalties due from it to the fee owners, was $77,505.98, and that it had no receipts during said year from any other source whatsoever. That its invested capital for and during said year 1917 was not to exceed $25,000.00, represented by its certificates of capital stock outstanding, it being true that during the year 1917 said Company did not employ any capital in any operations in its business or to produce its income for said year, and it also being true that prior to 1917 the Company had paid out to its stockholders several times the amount which originally had been put into said Company for said stock, and it being true that if the original $25,000.00 so paid in be considered as being returned to its stockholders ratably per ton as the ore was mined and paid for, according to the total tonnage in the properties, there was left on the 1st of January, 1917, only about $4,500.00 still unreturned, and if it be considered that its invested capital was the total sum

of $40,068.00 expended for exploration, plus the sum of $1,266.86 expended for other small items as set forth in paragraph 3 hereof, which were the only sums it ever spent, and that said sum was returned ratably per ton as the ore was mined and paid for, in proportion to the total tonnage, then said Company, on January 1, 1917, had only about $7,500.00 remaining still undistributed. That from said total net receipts of $77,505.98 for said year 1917 the said plaintiff was entitled to the said reasonable allowance of 71.9% of said receipts as depletion, amounting to $55,726.80, leaving its net taxable income for said year the sum of $21,779.18."

In the memorandum attached to the findings (Record p. 30), the District Court allowed our claim for depletion and assessed us under Section 201 of the law as to war and excess profits, which is the section applying generally to corporations, and the method of computation under that section is set out in Exhibit A attached to the findings of the court (Record p. 29). The method of figuring under that section as required by the law is quite complicated, but the Department has raised no question as to the figures in the Exhibit provided the principle is correct and we are entitled to depletion.

The District Court was of the opinion that the Alworth-Stephens Company in 1917 had an invested capital and more than a nominal capital, and says in its memorandum (Record p. 30):

"I am also of the opinion that the invested capital of the company was in 1917, $25,000, and that that invested capital could not be said to be not more than a nominal capital, and that, therefore, the levy and assessment could not be made under either Sections 209 or 210 of the Act, but must be made under Section 201.

"In short, I am of the opinion that the levy and assessment should have been made by first allowing depletion upon the basis above indicated, and then determining the

amount to be paid by considering the plaintiff as a corporation having an invested capital of $25,000."

Of course, if this Court holds, as we are confident it will, that we are entitled to deduction for depletion, that in itself results in an affirmance, and this argument under the second subdivision of our brief need not be considered. But it would also result in affirmance even if we were not so entitled and in fact in 1917 had no invested capital or only a nominal capital, for, as above pointed out, the figuring arrives at the same identical result in dollars and cents, no difference which claim is sustained, and the findings of the court are sufficient to sustain it if this contention is right.

We maintain on this proposition that the judgment should be sustained under Section 209 on one at least of the three following propositions:

(1) That in 1917 the Alworth-Stephens Company had no invested capital whatsoever, and therefore fell squarely within the provisions of Section 209.

(2) That under the findings of the court and the testimony of the government witnesses, we could not have had more than approximately $4,500.00 capital at the beginning of that year, which, under the law and the decisions, was only a nominal capital as compared with the income of $77,505.98, and therefore we were within the provisions of Section 209.

(3) That even on the extreme contention of the Government and the most unfavorable finding of facts to us, we had no more than $7,500.00 capital in 1917, which was nominal as compared with the income of $77,505.98, and puts us within said Section 209.

1. On the first of the above propositions, the facts as disclosed by the evidence and findings of the court are that there was never paid into this Company by its stockholders anything

more than the $25,000 in cash paid for stock on its organization (Record p. 22). The income tax law was first passed in 1913, the 1909 law being simply an excise tax on corporations for the privilege of doing business. By the end of 1909 there had been paid back to the stockholders and distributed by the Alworth-Stephens Company every cent of the capital that had ever been put into the company, and by 1913 several times this amount had been paid back and distributed to the stockholders (Record p. 24, par. 5). The company, therefore, had paid back to its stockholders, long before the tax amendment to the Constitution became effective, all of the capital which they had ever invested and much more, and we maintain, therefore, that it fell directly within Article 860 of the Regulations as to impairment of capital, above quoted, providing that "where there has been, directly or indirectly, a liquidation or return of their investment to the stockholders, in which case full effect must be given to any liquidation of the original capital". From the beginning of 1913 on, the corporation had no capital invested in its business, but had distributed all the capital which had ever been put into it. It never paid its officers or employes any salaries, had no office rent, no employes and carried on absolutely no business, the only thing done being to collect from its sub-lessees the royalties and pay the fee owners the amount going to them and distribute the balance to its stockholders (Record pp. 27). It was closing its affairs and going out of business as soon as these two mines were exhausted. In 1917 the only assets this company had were the two leases in question, which provided for royalties. *These royalties, being under the decisions, wholly income and being the only assets the company had in* 1917, *it therefore had no invested capital in* 1917 *and no capital.*

It had no other source than these leases out of which to get any money, and if *all the money* that it was to get *was income, then it certainly had no invested capital and no capital.* It is true the original certificates of stock for $25,000 had not been surrendered prior to 1917, but had been left outstanding as a

measure of distribution of these royalties between the stockholders. But the original and only investment of capital had been paid out by the company to its stockholders as early as 1909, and it never thereafter had any invested capital. Under these circumstances the fact that the certificates were still outstanding could certainly not mean more than that its capital was nominal, or in name only. For the actual money represented thereby had long since been paid out of the company into the hands of the stockholders. We therefore say that this particular company on these facts fell squarely within the provisions of Section 209, above quoted, and if so, it paid the full amount of its tax in 1918, and the additional assessment of $17,128.44 which the Government exacted and which the judgment of the District Court provided should be returned, was improperly exacted, and the judgment should be affirmed.

2. The government expert witness, Mr. Simcoe, claimed (Record pp. 68 to 84) that this original $25,000 of paid-in capital should, on some technical theory of accounting, be considered as returned to the stockholders ratably as they received their dividends, according to the number of tons mined each year, as measured by the total number of tons in the property, and his testimony, given after a full examination of the company's books, in substance was that if that theoretical method of distribution of capital were adopted, then there would be, at the beginning of 1917, approximately $4,500.00 of invested capital left. The district court found, in paragraph 14 (Record p. 27), as to that as follows:

> "and it being true that if the original $25,000.00 so paid in be considered as being returned to its stockholders ratably per ton as the ore was mined and paid for, according to the total tonnage in the properties, there was left on the 1st of January, 1917, only about $4,500.00 still unreturned."

Even if this method used by the government expert be adopted, we say that $4,500.00 of invested capital at the begin-

ning of 1917 was entirely nominal as compared with its income for 1917 of $77,505.98 and the income thereafter to be received by the exhaustion of the mines.

3. On the same theory Mr. Simcoe, the government expert, testified that if the invested capital was considered as originally the $25,000, plus about $16,000 additional which the company used for explorations, making a total of about $41,000 so used, was to be considered as having been at some time capital and paid ratably according as the ore was mined as compared to the total ore in the mine, there would be left in 1917 about $7,500.00 of capital undistributed. The court finds as to this (Record p. 27, par. 14):

> "and if it be considered that its invested capital was the total sum of $40,068.00 expended for exploration, plus the sum of $1,266.96 expended for other small items as set forth in paragraph 3 hereof, *which were the only sums it ever spent*, and that said sum was returned ratably per ton as the ore was mined and paid for, in proportion to the total tonnage, then said company, on January 1, 1917, had only about $7,500.00 remaining still undistributed."

The court also finds, in paragraph 9 (Record p. 24), that $17,858.50 of this total sum was in fact returned to the company in 1908 at the time the Perkins sub-lease was granted, on account of the amounts paid for exploration by this company on the property, and that this sum was immediately distributed to its stockholders. Therefore, at least this amount came back to the company in 1908 on account of the very expenditure it had made in that year, and was distributed to the stockholders. It is difficult, therefore, to see how any part of this could be considered as invested capital in 1917, nine years after it had all been paid back. It is only on the most technical theory of bookkeeping that it should be so considered. But even so there would be only about $7,500.00 capital left in 1917, or less than 10% of its receipts from royalties for that year, to say nothing of the

royalties which it would receive in the following years, and this we say was, under the authorities, only a nominal capital, as compared with its income, and the company even in that event was squarely within Section 209.

Furthermore, it is quite difficult to understand, if, as the Government contends, all of this Company's royalties were income, and if in 1917 it had nothing but royalties, and therefore nothing but income, and it did not then or thereafter have any other assets, how it could have any invested capital. If all in the world it owned was, under the decisions, income, then how could any part of the income be invested capital? If the whole is of one kind, how can a part of the whole be just the opposite kind? If the only asset the company had in the world was income, how can any part of that income be invested capital? This Company was not like a corporation which required capital to be kept intact in order to earn and produce income. It had no capital and required none to produce its income. When these leases and sub-leases were made the need for further capital ceased. From then on it was only a collecting and distributing agency, and the distributions completed before the end of 1909 amount to a wiping out and return of its capital. The law itself, in Section 207, defines invested capital as follows:

> "In the case of a corporation or partnership, (1) actual cash paid in, (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation or partnership, at the time of such payment (but in case such tangible property was paid in prior to January 1st, 1914, the actual cash value of such property as of January 1st, 1914, but in no case to exceed the par value of the original stock or shares specifically issued therefor), and (3) paid in or earned surplus and undivided profits used or employed in the business, exclusive of undivided profits earned during the taxable year."

The Alworth-Stephens Company never had any stock issued

for the leases which it took over. The only capital it ever had was cash paid for its shares. It never had any earned or paid-in surplus, because it always paid out to its stockholders, immediately upon receipt, all the income which it received (Record p. 24).

Article 860 of the Regulations, quoted above at length, provides:

> "Where there has been, directly or indirectly, a liquidation or return of their investment to the stockholders, in which case full effect must be given to any liquidation of the original capital."

Giving full effect to the return of the capital to the stockholders and thereby the liquidation of the original capital left this company without any invested capital or capital in 1917, and the company falls squarely within the statute and the regulations of the Department.

The Department has attempted to limit the application of Section 209 of the law to so-called "personal service corporations", without any justification for so doing in the language of the law itself and contrary to its plain meaning. This construction is not adopted by the courts, however. Of course, the ordinary corporation requires some invested capital in order to produce its income. Therefore the statute, before requiring an ordinary corporation to figure war excess profits at all, allowed it to deduct from 7 to 9% upon its invested capital under Section 203 of the statute, and the income of the ordinary corporation, to the extent of 7 to 9% of its invested capital, was subject to no excess profits tax whatsoever. The law-makers evidently considered that there would be some corporations, just like the Alworth-Stephens Company, which had no invested capital or not more than a nominal capital, and for such made the provision that they should pay a flat 8% on whatever income they had, after deducting a flat $3,000 (as a war profits tax, in addition

to the income tax of 6%, on the balance of income after deducting the war profits tax,) making a total of 14%, on all except the deductible items.

In *Delaski vs. Iredell*, 268 Fed. 377, affirmed by the Circuit Court of Appeals in 290 Fed. 955, the plaintiff company had an authorized capital of $100,000, and upon its organization experimented at great expense in the manufacture of automobile tires, and during that time developed a new form of mold for vulcanizing tires, upon which a patent was secured by the company. In 1911 it ceased doing any other business than granting licenses under the patent, and its capital stock was reduced to $10,000. During 1917 its capital was $10,000 and surplus $2,000, which was used as a fund to advance salaries, wages, provide office furniture, accommodations and equipment. The company's entire income for 1917 was $105,650.29, from which the court says it is clear the patents had a real value. The plaintiff claimed that it was entitled to be assessed under Section 209 of the Revenue Act of 1917, as a company having no invested capital or not more than a nominal capital. The Treasury Department denied this right and assessed it under Section 210 of the Act, just the same as the Treasury Department assessed the Alworth-Stephens Company. The court says:

> "The only invested capital of the plaintiff was the $12,000.00 of capital and surplus, which was not used in the production of the net income of the plaintiff, but merely for the purpose of advancing salaries, wages, and providing office accommodations and equipment, and which in itself, under treasury rulings, would not bring the company under section 201 of the act."

The Department made the contention that this Section 209 applied only to lawyers, doctors, professional men and high-salaried officers of corporations—in other words, personal service concerns. The court goes on to show that this could not be the

meaning of the act of Congress and quotes John Stewart Mill's definition of capital, as follows:

> "What capital does for production is to afford shelter, protection, tools, and materials which the work requires, and to feed and otherwise maintain the laborers during the process. Whatever things are destined for this use, destined to supply productive labor with these various prerequisites, are capital."

The court tested the case by this definition and held that the patents of the corporation, which produced the income, did not fall within the term "capital", and held, therefore, that the company had no invested capital and no capital, or not more than a nominal capital and was properly assessed under Section 209 of the law.

The leases which the Alworth-Stephens Company held and which produced the income, and nothing but income, were not capital, any more than the patents in the above case were. The Alworth-Stephens Company had no investment in them which could be treated as invested capital or capital, any more than as though they had been patents capable of producing an income. No investment was required to produce the income.

In *Cartier vs. Doyle*, 277 Fed. 150, the Court of Appeals of the Sixth Circuit held a partnership dealing in lumber assessable for the year 1917 under Seption 209 at 8%, as having no invested capital, where it did its entire business on borrowed money, although it borrowed large amounts. The court points out that under the rule in *Gould vs. Gould*, 245 U. S. 151, a taxing statute will not be extended by implication nor its provisions broadened to embrace matters not specifically covered. In this case, as in ours, considerable amounts had been distributed to the parties before 1917, but the court held the situation existing in 1917 governed.

In *Empire Fuel Co. vs. Hays*, 295 Fed. 704, the court held

that a mining corporation which had borrowed all of its money to purchase its property and for operating expenses had no invested capital and was taxable at the rate of 8% of its income under Section 209, and likewise called attention to the case of *Gould vs. Gould* in this court, holding that it is the rule that courts will not enlarge the operation of a taxing statute so as to embrace matters not specifically covered and will construe a taxing statute in favor of the taxpayer.

In *Porter vs. Lederer*, 267 Fed. 739, the court held that a firm principally engaged in the commission business was properly taxable under Section 209, even though its profits had accumulated until they reached the sum of about $36,000, and even though the firm on account of war conditions actually had more or less isolated transactions in which they bought and sold commodities.

The Department has attempted to assess the Alworth-Stephens Company under Section 210 of the law, which provides for an arbitrary assessment by the Secretary of the Treasury where he is unable in any case satisfactorily to determine the invested capital, and where he is supposed to make the assessment merely by comparison with other representative corporations, partnerships and individuals, without in any manner even disclosing to the taxpayer with what companies the comparison is made. There was absolutely no justification for putting this company under that section. Its records were clear. The facts were absolutely established. If the company had an invested capital the facts were easily ascertainable, and on the facts it is merely a question of whether it had or had not an invested capital. If it had, then we are properly assessable under Section 201 of the law, and if it had not an invested capital, or only a nominal capital, then we fell squarely within Section 209.

It is true that if we are first entitled to a depletion, as hereinbefore argued, and we are next entitled to have the tax assessed under Section 209, our tax would have resulted in only about one-

fourth of the tax which we paid in the first instance and which the lower court has found was due. However, when we put in our return for 1917, the law was new, the war was on, and this company felt that it was paying the highest amount of tax that in any reason could be required of it, and it was not attempting in any manner to shirk its full tax burden. Notwithstanding it did not agree with the rulings of the Department as to depletion, it then paid its tax and supposed that it had done all that in any reason could be expected of it ,and has since been harrassed by the Department through long correspondence and forced to pay this $17,128.44 additional and to bring suit therefor, which has been proceeding through the courts for some four years.

We submit that the judgment must be affirmed.

Respectfully submitted,

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